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CONSUMER CREDIT INTEREST RATES

HEARING

BEFORE THE

SUBCOMMITTEE ON CONSUMER AFFAIRS

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

TO DETERMINE THE REASONS WHY CONSUMER CREDIT RATES CHARGED BY BANKS HAVE REMAINED AT DRAMATICALLY HIGH LEVELS ALTHOUGH THE INFLATION RATE HAS DECLINED SHARPLY

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CONSUMER CREDIT INTEREST RATES

WEDNESDAY, MARCH 17, 1983

U.S. SENATE,
SUBCOMMITTEE ON CONSUMER AFFAIRS,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, D.C.

The subcommittee met at 9:30 a.m. in room 538 of the Dirksen Senate Office Building, Senator Paula Hawkins (chairman of the subcommittee) presiding.

Present: Senators Hawkins, Gorton and Proxmire.

Senator HAWKINS. Good morning. I'm Senator Paula Hawkins. We're here today to hold oversight hearings to determine the reasons why consumer credit rates charged by banks have remained at dramatically high levels although the inflation rate has declined sharply. The Consumer Affairs Subcommittee is interested in determining whether lending rates charged have been abnormally high relative to the cost of funds. I am happy to welcome Senator Pressler this morning and the group of fine mayors from his State. Senator Pressler will be our first witness.

STATEMENT OF LARRY PRESSLER, U.S. SENATOR, STATE OF SOUTH DAKOTA

Senator PRESSLER. First of all, let me commend you, Senator Paula Hawkins, for holding these hearings and starting what I think should be an investigation of why interest rates to consumers remain so high. People say to me, "We hear on television that there's 9 percent money or 10 percent money, but we're paying 16 and 17 percent." Indeed, even our public agencies, are experiencing difficulties. Yesterday the Web Water Project in South Dakota, one of our public projects, was told that their interest rates will be much higher than they had anticipated. The Web officials were in Washington to meet with the various agencies and our congressional delegation went with them to talk about the interest rates that are well above the discount rate.

I'm proud to say that I have several mayors from South Dakota here who are here at a conference to talk with Government officials. Even municipalities that borrow money—are having difficulties with high interest rates. If I could be indulged, I would like the mayors from South Dakota who are here to stand up for a minute if that's possible.

[Mayors stand up.]

Senator PRESSLER. I'm very proud of them and they are bringing a message from small town America to various Government agencies.

Madam Chair, I'm pleased today to have the opportunity to testify before your subcommittee on the Senate Banking Committee concerning consumer interest rates. As the Chair knows, I have recently written a letter to Senator Garn, chairman of the Banking Committee, asking him to hold hearings on this very subject. I'm pleased that the committee has acted so swiftly to address this serious problem.

Consumers in America are curious as to why interest rates remain so high although we are told over and over that the prime has gone down. Way back in January 1981, I was the first Republican Senator who warned President Reagan that high interest rates could be the Achilles heel of the whole economic program. In my State of South Dakota, which includes small businesses, agriculture, and wage earners, high interest rates are perhaps as important a factor as anything to creating jobs and having economic recovery.

Since that time I have met repeatedly with Chairman Paul Volcker of the Federal Reserve Board and have testified before this committee in an effort to bring attention to the severe difficulties which interest rates have caused most Americans. I also introduced legislation during the last Congress to alter the makeup of the Federal Reserve Board to include small business and agricultural representatives. I believe my legislation and the legislation of others sent a strong signal to the Federal Reserve Board that both the discount rates and the money supply mechanisms had to be adjusted and interest rates had to come down for an economic recovery. I believe that message has been heard and I would applaud President Reagan for working with Chairman Volcker in this past year to get the prime down.

During my listening meetings in South Dakota in February, I found that a common complaint was that the interest rates really haven't gone down to those of us who are consumers although loans to the big corporations and preferred customers have come down.

When the prime was going up, the interest rates went right along with it. Yet now while the prime is going down, the interest rates are not coming down with it. The banks use the argument that they have money out at a higher rate, but the reverse argument would then have been true when the prime was going up. Someone is making an unfair profit in my view.

Now while I do not agree that the Federal Reserve Board should neglect further action to lower interest rates, I do share the President's concern that the large banks of our Nation may be keeping interest rates artificially high, and I applaud the President for making that statement. I am particularly troubled that consumer rates have remained close to 20 percent in some parts of the country in spite of the fact that the prime rate has fallen from 21 to 10.5 percent.

ECONOMIC RECOVERY

There have been some encouraging signs of economic recovery nationwide, but let me say that we also have very high unemployment and in my State of South Dakota in the smaller cities and

towns we have very hard economic times which are largely related to interest rates.

There can be no real recovery until interest rates for average Americans are reduced. Our farmers, small business people, and wage earners continue to struggle under the burden of high interest rates, a burden that has already contributed to record bankruptcies.

Frankly, many Americans have become disillusioned because of the huge gap between the interest costs they pay and the lower prime rate that is receiving so much media attention. I am disillusioned as well. It is time for Congress to look into this serious problem. Charges have been made that the large banks are keeping interest rates high to cover their losses on bad international and domestic loans. These are not charges that can be easily dismissed, not when they are so vital to the economic well-being of our Nation.

As I mentioned earlier, several mayors of my home State of South Dakota are meeting here in Washington at my invitation. I know that they too are feeling the effects of high interest rates in the credit for their cities. As our small rural towns struggle with a reduced tax base and the problem of borrowing funds at higher rates, they need assurances from Washington that interest costs are not being unfairly manipulated.

Once again, I want to commend the Banking Committee for looking into this problem. Again, thank you, Senator Hawkins, for your outstanding leadership in calling these hearings.

I thank you very much.

STATEMENT OF SENATOR HAWKINS

Senator HAWKINS. Thank you, Senator Pressler. We appreciate your interest and it's been my experience working with you that you're a Senator who not only cares but is concerned in participating in these dialogs to help America back to recovery. We thank you for taking the time to be with us today.

Just in commenting on what Senator Pressler said, I have a page from Business Week, March 14, that states, "The consumer is no dummy. He knows that lower inflation should produce lower rates and he's waiting until lenders get the message." And that's the message we have been getting, Senator Pressler in his home State, and I go to Florida every weekend. We are waiting for the consumers to lead us to recovery. Unemployment remains unacceptably high. To me the only way we can rebuild America is to get these interest rates down. That's the purpose of these hearings today.

Judging from the official evidence this appears to cause a lot of problems throughout the country. The rates varied as much as 16 percent to 17.9 percent for car loans in my State of Florida last week. Everyone is trying to determine whether lending rates charged are abnormally high relative to the cost of acquiring funds to lend. Who is making the profit, as Senator Pressler said?

During the period from November 1980 to November 1982, the Consumer Price Index that we hear about once a month, the CPI, declined by more than two-thirds. During the same period, the 3-month certificate of deposit rate or the CD rate, which is the meas-

ure of the cost banks pay for funds, declined from 16 percent to 9 percent or almost one-half. By comparison, the rates that the banks charged their credit card customers went up over 2 points, from 16 to 18 percent, during the same period.

The bank rate for 12-month loans rose from 15 percent to 18 percent. Rates on new autos rose from 14 percent to 16 percent or 17.9 percent in some areas.

The cost of funds is only one component in the total cost of providing consumer credit. Rapid increases in operating costs and bad loans, that we constantly read about in the newspapers—those could keep rates high despite the sharp declines in the cost of funds.

Since operating costs have represented the larger portion of total costs of providing consumer loans as compared to large commercial loans, they are an especially important component of consumer interest rates. But operating costs should be falling as lenders become more efficient in the use of computer technology. Productivity growth, if passed on to the consumer, should result in interest rate savings.

That leaves bad loans as a possible source of upward interest rate pressure. Indeed, bad loans appear to be sharply on the rise. Hundreds of billions of dollars of foreign loans are euphemistically being rescheduled. Closer to home, a weak economy and falling energy prices have caused many firms to default on their loans and passage of the Bankruptcy Reform Act in 1978 has led to a significant increase in the amount of consumer loans written off.

These extra costs may be passed on to consumers and other borrowers in the form of higher interest rates.

We are left then with two possible conclusions. Either lenders are not passing through their savings to consumers, or the rising level of bad debts due to imprudent lending means there are no savings to share.

Today's hearing will help establish which explanation is the most persuasive or if there may be other explanations. These are troubling possibilities. If rates are unnecessarily high, whether due to profiteering or poor management, that's unacceptable. They're costing consumers billions of dollars and many jobs and the failure of rates to come down impedes our economic recovery causing millions of Americans to remain unemployed.

I'm glad to welcome Senator Proxmire here. Do you have a statement?

Senator PROXMIRE. No.

Senator HAWKINS. All right. We would like to call the first panel of witnesses who will be here with us today: Hon. William Poole, who's a member of the Council of Economic Advisers; Hon. Preston Martin, vice chairman of the Board of Governors; and Hon. Manuel Johnson, Assistant Secretary for Economic Policy.

I think you gentlemen received the communication from us that you could submit your statement for the record and have a summary of your statement at this time. We call on Mr. Poole first.

STATEMENT OF WILLIAM POOLE, MEMBER, COUNCIL OF ECONOMIC ADVISERS

[The complete statement follows:]

Statement

of

William Poole, Member
Council of Economic Advisers

I am very pleased to be here this morning to share with you my analysis of recent interest rate trends.

The subject of these hearings -- the behavior of interest rates -- is extremely important, but also extremely complex. The determinants of real rates of interest, inflationary expectations, and the spread between lending rates and the cost of funds to financial institutions are not completely understood. Because my time is brief, and the overall subject so large, I will concentrate on the issue of the differentials between open market interest rates and interest rates paid by consumers and businesses.

Consumer Loan Rates

As is well known, consumer loan rates are higher than open market rates on instruments such as U. S. Treasury bills and commercial paper. These open market rates provide a good measure of the cost of funds to financial institutions in the relevant sense of opportunity cost. Financial institutions always have the choice of investing in open market paper rather than making loans, and when loan demand is weak that is exactly what they do.

There are a number of reasons why consumer loan rates are higher than open market rates. One is that the interest rates in the open market are, so to speak, "wholesale" rates; that is, these are the rates on large denomination securities. Smaller sized loans, reflecting "retail" business, necessarily

carry higher rates because of the costs of providing relatively small loans to individual borrowers.

A second important factor is that the rates quoted in the open market are on risk-free, or nearly risk-free, financial instruments. Consumer loan rates must include an allowance for default risk. In times of recession, when unemployment rises, default risk rises. Financial institutions, lending the savings entrusted to them by millions of Americans, must be sensitive to default risk.

The importance of these factors in making consumer loan rates higher than open market rates is generally understood. At the present time, however, there is a special concern that the margin between consumer loan rates and open market rates is unusally high. That is an issue that can be addressed by a close examination of the data.

Before turning to the data, there is one other factor at work that needs to be discussed. That factor, which is especially important today, is the tendency for consumer loan rates to lag behind the open market rates. The lag works in both directions; when open market rates rise consumer loan rates tend not to rise as quickly, and when open market rates fall consumer loan rates tend not to fall as quickly.

The reason for the lag is no doubt the problem each financial institution faces in administering its consumer loan business. A financial institution may be making hundreds and even thousands of loans each month. A wide variety of considerations is involved in each loan decision. Loan officers must make credit decisions after evaluating the credit

worthiness of potential borrowers and the security of the collateral offered, if any. A complicated administrative task of this kind cannot be managed if the criteria applied by the loan officers change too often. Thus, the interest rate, which is one of several important terms of a consumer loan agreement, is generally changed from time to time rather than every day, and so interest rates on consumer loans tend to lag interest rates in the open market.

Now let us look at the data. The top panel of Chart 1 shows the 36-month new auto loan rate and the 3-year constant maturity Treasury yield. The 3-year Treasury yield provides a good open market reference rate because Treasury securities are traded actively in an excellent market.

The bottom panel of the chart shows the differential between the two rates. The current differential is high, but not abnormally so based on past experience. Moreover, the chart shows very clearly the tendency of the auto loan rate to lag the 3-year Treasury rate. Declines in the Treasury rate during recession, as in late 1974 and early 1980, were not accompanied by equally rapid declines in the auto loan rate. Nor was the period of rising Treasury rates in 1977-78 accompanied by a rising auto loan rate.

Chart 2 provides a similar perspective on 24-month consumer goods loans. These loans are used to finance such items as furniture and home appliances. As with auto loans, the interest rate differential, using the 3-year Treasury rate as the reference rate, is high but not abnormally high.

Business Loan Rates

Considerations similar to those discussed above for the consumer loans apply to many business loans, especially loans to small businesses. Analysis of business loan rates is obviously important in its own right, and is also useful in reinforcing our understanding of the determinants of consumer loan rates. To understand business loan rates, however, we must account for an additional consideration that has become important in recent years -- the changing significance of the prime rate.

The prime rate is the most often quoted reference point in judging business loan rates. The prime rate, though, is changing in significance. It used to be that the prime rate was quite literally the lowest rate at which even the most credit-worthy business borrowers were able to obtain credit from banks. In recent years the situation has changed. The business loan market seems to have become more competitive with the result that a significant number of loans are now made at rates below prime. These loans go to the very best credit risks -- those having access to open market commercial paper rates. The expansion of the commercial paper market means that banks simply must be competitive with commercial paper rates or they will not get the business because the best credit risks will turn to the commercial paper market instead. This phenomenon provides an excellent illustration of how competitive the credit markets have become in recent years.

A good indication of what has happened can be obtained from examining Table 1 on business lending. This table has been reproduced from the February 1983 Federal Reserve

Bulletin. The table reports the results of the Federal Reserve's business loan survey made in early November 1982. At that time the prime rate was 12 percent while the commercial paper rate was about 8-3/4 percent. From line 4 of the table we see that the weighted average interest rate on all short-term business loans at the time of the survey was 11.26 percent, a rate well below the 12 percent prime in effect at that time. The table also shows clearly that the interest rate on business loans declines as the size of the loan increases. Indeed, for very large loans of $1 million and above the weighted average interest rate was 10.79 percent, a figure significantly below the prime rate.

The situation in November 1982 may be compared to the one in February 1975. Table 2 is reproduced from the Federal Reserve Bulletin for June 1975. The Fed's business loan survey was somewhat different at that time. Nevertheless, the survey in February 1975 indicated an average loan rate for short-term loans of 9.94 percent compared to a prime rate at that time in the neighborhood of 9 percent, as can be seen from the table on the prime rate at the top of that same page. The average rate on large loans of $1 million and over on a revolving credit basis was 8.98 percent, a figure just about equal to the prime rate. Only in New York City, the financial center of the world, were rates on large loans significantly below the prime rate. Given that the rate on prime commercial paper was 6.5 percent in February 1975, it is hardly surprising that the rate on very large loans in New York was below the 9 percent prime rate.

The data on business loan rates support the same conclusion as that drawn for consumer loans: rates are significantly affected by default risk, differ by size of loan, and tend to lag behind open market interest rates. However, the lag in business loan rate is not as dramatic as with the consumer loan rate. Chart 3 shows the prime rate and the 3-month Treasury bill rate, and the differential between the two. For an even longer historical perspective, Chart 4 is reproduced from the Federal Reserve's 1982 Historical Chartbook.

Conclusions

The financial markets in the United States are extremely competitive. The interest rates paid by both businesses and consumers are quite finely tuned to the cost of making loans, including the cost of funds to lenders, costs due to default risk, and the costs of making and administering loans. Using the most recently available data (December 31, 1981), in the United States there are 14,882 commercial banks, 4,347 savings and loan associations, and 441 mutual savings banks. Altogether, these three types of financial institutions have 65,682 offices. In addition, there are 20,759 credit unions, and 2,775 finance companies (June 30, 1980). Adding these figures together, there are 43,204 separate firms of the types listed competing in the credit markets. Other financial institutions, such as insurance companies, are also important. Direct access to the credit market, by by-passing financial intermediaries, is an additional option for most medium- and large-sized firms.

Although many of these financial firms are small, they compete vigorously in an effort to grow in size and profitability. Because of the huge number of competing financial firms, there is little possibility for any of them, even the largest, to make up losses on some loans by charging higher rates on other loans.

Perhaps the most important feature of the current situation is the normal lag of rates charged by financial institutions behind open market rates. If open market rates stay down -- and all of us are bending our best efforts to that end -- the rates paid by consumers and small business will likely fall in the months ahead.

We must not forget, however, that the differentials between the loan rates and the open market rates can be closed in two ways -- the loan rates can fall or the open market rates can rise. High open market rates are fundamentally the result of inflation; to avoid a resurgence of inflation we must follow a disciplined monetary policy.

Such a monetary policy will require, from time to time, that we be willing to accept temporary increases in open market interest rates in order to restrain monetary expansion to an appropriate, noninflationary pace. My earlier analysis should help to provide a perspective on the implications of temporary increases in open market rates, if they should occur. The rates paid by consumers and small business tend to lag behind open market rates, in both directions. Thus, no important effects need be feared on the key consumer and small business sectors of our economy from a policy of monetary discipline. To the contrary, the failure to follow a disciplined monetary policy will insure that inflation will accelerate, leading to another boom-bust cycle in the U. S. economy. That is the outcome we must fear the most.

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Table 1

1.34 TERMS OF LENDING AT COMMERCIAL BANKS Survey of Loans Made, November 1–6, 1982

Item	All sizes	Size of loan (in thousands of dollars)					
		1–24	25–49	50–99	100–499	500–999	1,000 and over
Short-Term Commercial and Industrial Loans							
1 Amount of loans (thousands of dollars)	37,830,563	1,004,140	642,584	562,394	2,129,432	913,862	32,578,151
2 Number of loans	170,984	123,157	20,331	9,027	12,408	1,403	4,658
3 Weighted-average maturity (months)	1.2	3.6	3.6	4.1	4.8	3.2	.8
4 Weighted-average interest rate (percent per annum)	11.26	15.63	15.32	13.80	13.85	12.93	10.79
5 Interquartile range[1]	10.38–11.34	14.37–16.99	13.72–16.45	12.68–14.45	12.68–13.01	12.25–13.80	10.38–10.90
Percentage of amount of loans							
6 With floating rate	26.4	32.5	39.5	70.8	65.4	65.0	21.6
7 Made under commitment	70.1	40.8	35.8	64.5	54.4	68.9	72.8
8 With no stated maturity	9.6	15.9	18.7	40.0	22.2	29.5	7.3
Long-Term Commercial and Industrial Loans		1–99					
9 Amount of loans (thousands of dollars)	4,007,972	380,177			439,970	204,266	2,963,558
10 Number of loans	25,270	22,129			2,265	311	565
11 Weighted-average maturity (months)	46.2	43.9			28.4	45.3	49.6
12 Weighted-average interest rate (percent per annum)	12.24	15.17			13.98	13.02	11.54
13 Interquartile range[1]	10.68–13.55	13.80–16.65			13.50–14.94	12.55–13.88	10.62–12.68
Percentage of amount of loans							
14 With floating rate	77.8	49.0			67.9	81.6	82.7
15 Made under commitment	76.1	44.1			32.4	69.6	87.5
Construction and Land Development Loans		1–24	25–49	50–99		100 and over	
16 Amount of loans (thousands of dollars)	1,433,072	157,866	179,347	85,282	531,567	479,01	
17 Number of loans	25,255	16,181	4,750	1,278	2,806	1	
18 Weighted-average maturity (months)	11.1	14.4	16.0	6.4	8.3	12.2	
19 Weighted-average interest rate (percent per annum)	15.14	16.74	17.44	18.52	15.01	13.30	
20 Interquartile range[1]	12.73–16.09	15.02–18.10	14.75–18.97	14.23–20.57	12.69–15.58	11.82–14.50	
Percentage of amount of loans							
21 With floating rate	56.6	27.8	27.2	34.9	47.4	91.1	
22 Secured by real estate	71.6	75.0	85.6	92.8	69.2	64.3	
23 Made under commitment	39.6	44.4	43.1	29.7	21.5	38.7	
24 With no stated maturity	2.9	3.7	4	4.8	2.1	4.0	
Type of construction							
25 1- to 4-family	43.3	74.8	64.2	72.2	56.7	5.2	
26 Multifamily	12.1	1.5	10.8	7.6	4.6	22.2	
27 Nonresidential	44.6	23.7	17.0	20.2	38.7	72.6	
Loans to Farmers	All sizes	1–9	10–24	25–49	50–99	100–249	250 and over
28 Amount of loans (thousands of dollars)	1,457,533	158,122	234,089	169,062	282,570	200,860	412,831
29 Number of loans	67,611	40,418	15,969	5,177	4,206	1,304	536
30 Weighted-average maturity (months)	5.8	5.4	7.1	6.4	5.7	6.1	4.7
31 Weighted-average interest rate (percent per annum)	14.84	15.60	15.38	15.34	15.57	15.01	13.46
32 Interquartile range[1]	13.96–15.71	15.00–16.21	14.65–16.11	14.57–16.02	15.03–16.08	14.00–15.57	11.01–15.22
By purpose of loan							
33 Feeder livestock	13.90	15.48	15.19	15.22	15.01	14.35	12.66
34 Other livestock	15.49	15.46	15.42	15.34	15.58	*	*
35 Other current operating expenses	15.33	15.65	15.40	15.42	15.50	14.56	15.20
36 Farm machinery and equipment	15.68	15.53	15.16	15.76	*	*	*
37 Other	14.53	15.62	15.66	14.84	16.26	14.65	13.74

1. Interest rate range that covers the middle 50 percent of the total dollar amount of loans made.
2. Fewer than 10 sample loans.

NOTE. For more detail, see the Board's E.2 (111) statistical release.

Table 2

PRIME RATE CHARGED BY BANKS

(Per cent per annum)

Effective date	Rate	Effective date	Rate	Effective date	Rate	Effective date	Rate
1974—Apr. 11	9¾–9⅞–10■	1974—June 3	11½■–11⅝–11¾	1974—Oct. 28	10¾–11–11½■–11½	1975—Feb. 3	8¾–9–9¼■–9½–9¾
15	10■–10⅛–10¼	7	11¼–11½■–11⅝	Nov. 4	10¾–11■–11¼	4	8¾–9–9¼■
19	10–10⅛–10¼■	10	11½■	11	10½–10¾–11■	10	8¼–9■
Apr. 23	10¼■–10⅛	21	11¼–11½■	14	10½–10¾■–11	13	8½–8¾■–9
24	10½■–10⅛–11	24	11½■–11¾	18	10–10½–10¾■	24	8½■–8¾
25	10¼–10⅛–10½■	25	11½■–11¾–11⅝	19	10–10¼–10½–10¼■	Mar. 3	8¼–8½■
26	10⅛–10½■–10¾–11	26	11½–11¾■–11⅝	25	10–10¼–10½■	5	8¼–8½
30	10½■–10⅛■–10¼–11	28	11¾■–11⅝	Dec. 2	9¼–10–10¼–10½■	6	7¾–8¼■–8½
May 2	10½–10⅛–10¾■–11	July 3	11¾■–11⅝–12	1975—Jan. 9	9½–10–10¼■–10½	10	7¾–8■–8¼
3	10⅛–10¾■–11	5	11⅝–12■	13	9½–9¾–10–10¼■	17	7¾–8■
6	10⅛–10¾–11■	9	12■–12¼	15	9¼–9¾–10■–10¼	18	7½–7¾■–8
7	11■	23	10¾–12■–12¼	20	9½–9¾■–10	24	7½■–7¾–8
10	11–11¼■	Aug. 20	10¾–12■	28	9½■–9¾–10	25	7½■–7¾
13	11¼■–11⅛	Sept. 26	10¾–11½–11¾–12■	29	9½■–9¾	31	7¼–7½■–7¾
17	11¼–11–⅛–11½■	Oct. 7	10¾–11½–11¾■–12			May 20	7¼■–7½
20	11½■–11¾	15	10¾–11¼–11½–11¾■			26	7–7¼■–7½
		21	10¾–11¼–11½■–11¾				

NOTE.—Beginning Nov. 1971, several banks adopted a floating prime rate keyed to money market variables. ■ denotes the predominant prime rate quoted by commercial banks to large businesses.

Effective Apr. 16, 1973, with the adoption of a two-tier or "dual prime rate," this table shows only the "large-business prime rate," which is the range of rates charged by commercial banks on short-term loans to large businesses with the highest credit standing.

RATES ON BUSINESS LOANS OF BANKS

Center	All sizes		Size of loan (in thousands of dollars)									
			1–9		10–99		100–499		500–999		1,000 and over	
	Feb. 1975	Nov. 1974	Feb. 1975	Nov. 1974	Feb. 1975	Nov. 1974	Feb. 1975	Nov. 1974	Feb. 1975	Nov. 1974	Feb. 1975	Nov. 1974
Short-term												
35 centers	9.94	11.64	10.94	11.81	10.73	12.04	10.25	11.97	9.93	11.80	9.73	11.44
New York City	9.61	11.35	10.82	12.31	10.60	12.11	10.14	12.05	9.74	11.56	9.50	11.21
7 Other Northeast	10.31	12.22	12.07	13.03	11.31	12.84	10.64	12.46	10.09	12.34	9.96	11.91
8 North Central	9.87	11.66	10.55	11.54	10.49	11.99	10.09	11.93	9.85	11.77	9.74	11.53
7 Southeast	10.24	11.52	10.59	11.44	10.52	11.34	10.21	11.43	10.22	11.62	10.12	11.62
8 Southwest	10.01	11.56	10.36	10.87	10.47	11.64	10.11	11.77	9.83	11.74	9.84	11.36
4 West Coast	9.99	11.48	11.23	12.26	10.75	11.99	10.22	11.86	10.05	11.56	9.84	11.32
Revolving credit												
35 centers	9.20	11.60	11.03	12.71	10.56	12.00	10.14	11.99	10.18	11.60	8.98	11.56
New York City	7.84	11.60	10.98	12.25	10.59	11.97	9.98	11.89	9.87	11.77	7.61	11.57
7 Other Northeast	10.83	12.26	12.05	12.08	10.60	11.98	9.97	11.68	10.98	11.75	10.90	12.50
8 North Central	10.32	11.82	11.77	13.34	11.14	12.29	10.97	12.57	10.24	11.79	10.22	11.72
7 Southeast	9.77	11.53	10.61	.....	10.41	11.41	10.35	13.09	9.00	10.98	9.76	11.25
8 Southwest	10.54	12.06	11.61	13.03	11.18	12.33	10.57	12.28	10.75	11.82	10.37	12.06
4 West Coast	9.52	11.39	10.67	12.70	10.13	11.89	9.77	11.68	10.17	11.57	9.40	11.33
Long-term												
35 centers	10.26	12.16	10.54	11.74	10.55	12.04	10.57	12.09	10.16	11.71	10.21	12.23
New York City	9.62	11.96	9.27	8.87	10.82	11.45	10.46	12.37	9.78	12.02	9.53	11.93
7 Other Northeast	10.48	12.35	10.99	12.66	10.77	12.52	10.51	11.98	10.20	11.55	10.49	12.61
8 North Central	11.33	12.29	10.32	10.90	10.25	11.89	10.17	11.90	9.45	11.75	11.81	12.44
7 Southeast	10.42	13.81	9.67	11.21	10.47	11.45	11.11	12.14	11.95	12.02	9.16	17.29
8 Southwest	9.87	12.27	11.99	12.39	10.12	12.18	10.46	12.28	10.09	12.68	9.60	12.49
4 West Coast	10.07	12.01	8.36	12.75	10.77	11.99	11.28	12.04	10.94	11.60	9.78	12.06

CHART 1

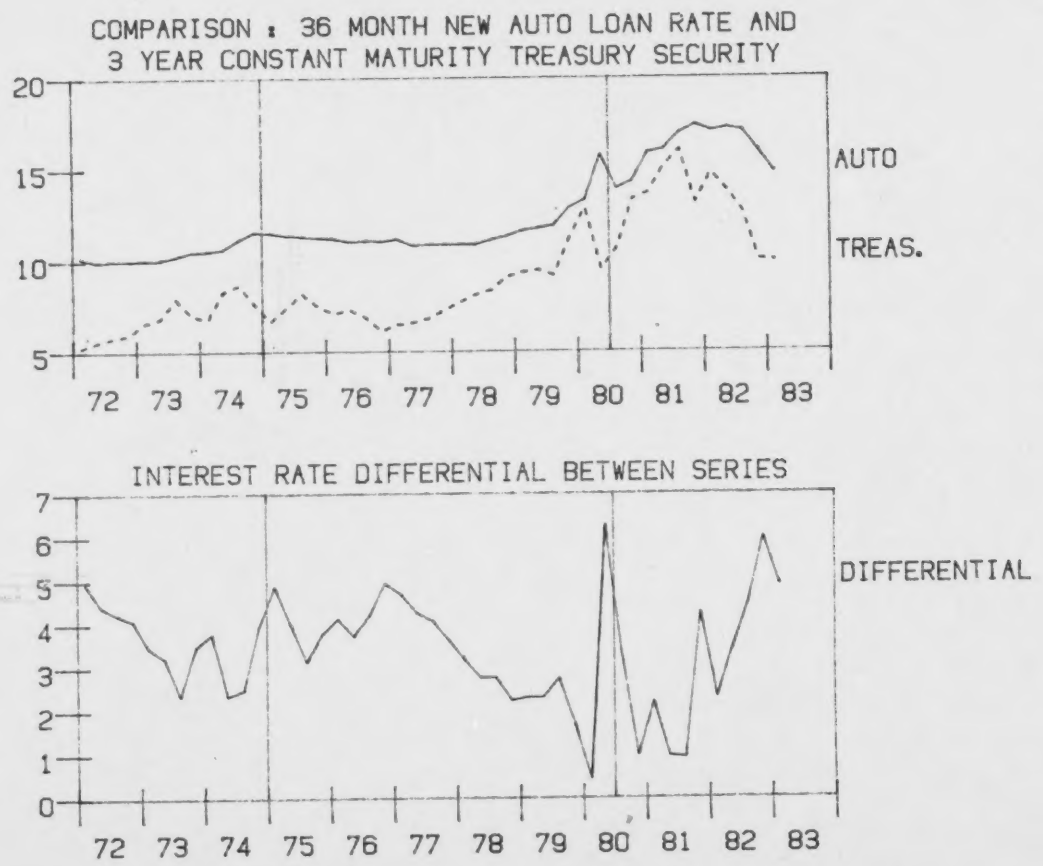

COMPARISON : 36 MONTH NEW AUTO LOAN RATE AND
3 YEAR CONSTANT MATURITY TREASURY SECURITY
20
15
10
5
AUTO
TREAS.
72 73 74 75 76 77 78 79 80 81 82 83
INTEREST RATE DIFFERENTIAL BETWEEN SERIES
7
6
5
4
3
2
1
0
DIFFERENTIAL
72 73 74 75 76 77 78 79 80 81 82 83

CHART 2

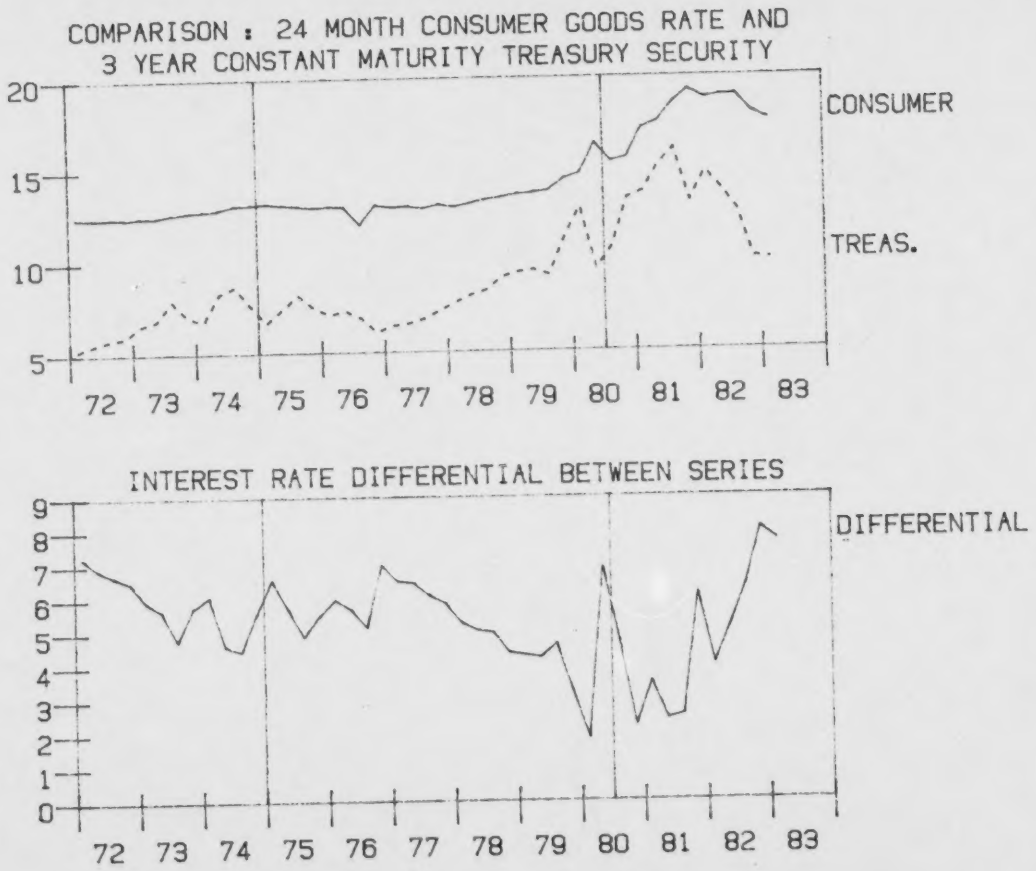

COMPARISON : 24 MONTH CONSUMER GOODS RATE AND
3 YEAR CONSTANT MATURITY TREASURY SECURITY
20
15
10
5
CONSUMER
TREAS.
72 73 74 75 76 77 78 79 80 81 82 83
INTEREST RATE DIFFERENTIAL BETWEEN SERIES
9
8
7
6
5
4
3
2
1
0
DIFFERENTIAL
72 73 74 75 76 77 78 79 80 81 82 83

CHART 3

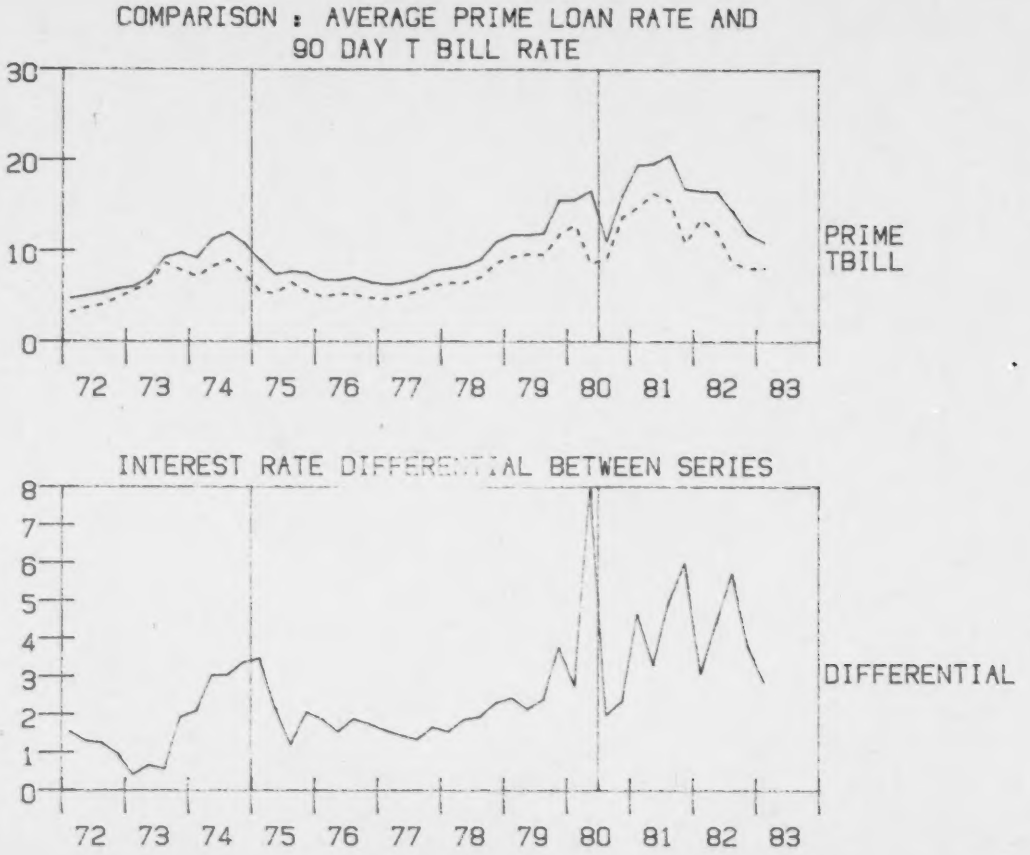
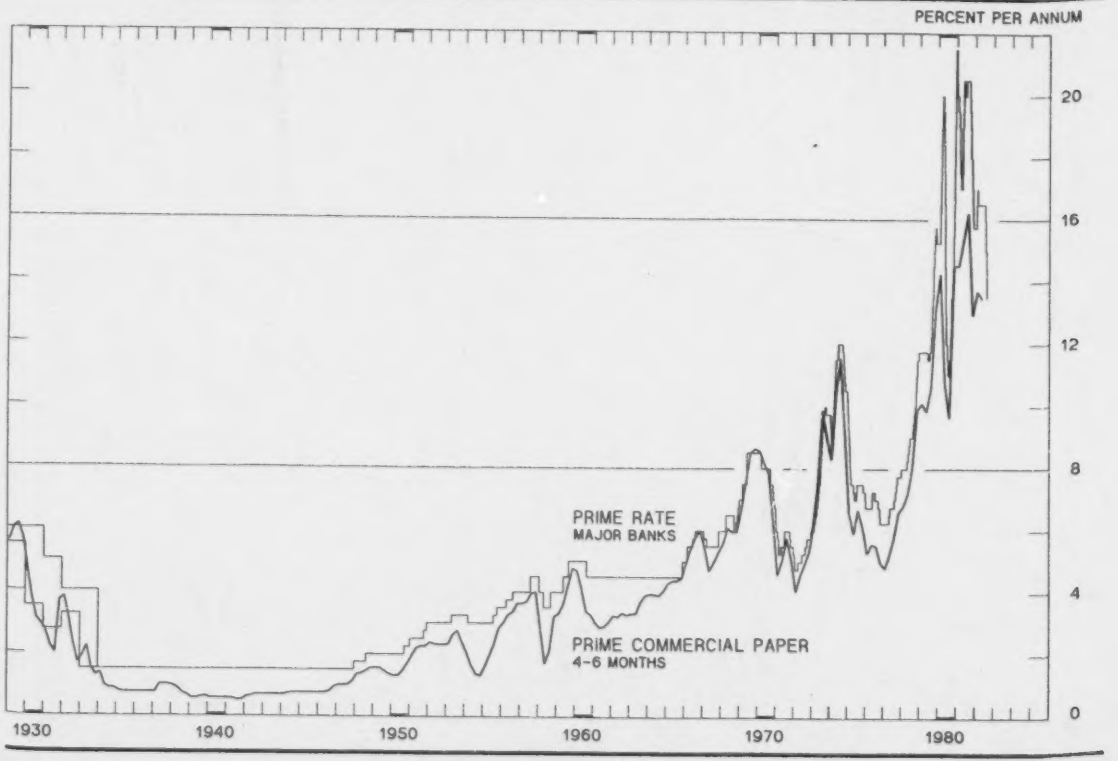

COMPARISON : AVERAGE PRIME LOAN RATE AND
90 DAY T BILL RATE
30
20
10
0
72 73 74 75 76 77 78 79 80 81 82 83
PRIME
TBILL
INTEREST RATE DIFFERENTIAL BETWEEN SERIES
8
7
6
5
4
3
2
1
0
72 73 74 75 76 77 78 79 80 81 82 83
DIFFERENTIAL

CHART 4

SHORT-TERM INTEREST RATES

BUSINESS BORROWING

PRIME RATE, EFFECTIVE DATE OF CHANGE; PRIME PAPER, QUARTERLY AVERAGES



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Senator HAWKINS. Thank you. Mr. Johnson.

STATEMENT OF MANUEL JOHNSON, ASSISTANT SECRETARY FOR ECONOMIC POLICY, DEPARTMENT OF THE TREASURY

[The complete statement follows:]

STATEMENT OF MANUEL H. JOHNSON, ASSISTANT SECRETARY FOR ECONOMIC POLICY, TREASURY DEPARTMENT

It is a pleasure to be with you today to inquire into the reasons why interest rates in general, and those paid by consumers in particular, have remained at relatively high levels. It seems to me that high interest rates—in both nominal and real terms—are a direct consequence of the way that the economy has performed for a decade or more and the policies that have been followed. Therefore, my statement today deals mainly with the broad economic forces which have determined the general level of interest rates.

INTEREST RATES AND THE ECONOMY

Nominal interest rates are down sharply from their peak levels but they remain high by historical standards. For example, the 3-month Treasury bill has recently been trading around 8¼ percent on a bank discount basis, less than one-half of its late 1980 peak of 17.14 percent, and down about 4 percentage points since last summer. The commercial bank prime lending rate is currently at 10½ percent, less than one-half of the 21½-percent peak first reached in late 1980 and down 6 percentage points since last summer. The economy is still in the early stages of cyclical recovery and interest rates can still decline somewhat further but that depends primarily upon our making continued progress against inflation, achieving moderate rates of monetary growth and reducing financial risk in general.

Inflation already experienced over the past 15 years and feared in the future is the fundamental reason for high nominal interest rates. Rising rates of inflation after the mid-1960's led to a roughly parallel rise in key interest rates. Chart I, attached to my prepared statement, shows a close relationship over the period between the 3-month Treasury bill rate and the annual rate of inflation. Sustained periods of monetary over-expansion drive up the rate of inflation and pull up the entire structure of interest rates. That is what occurred following the mid-1960's.

The relationship between inflation and nominal interest rates is relatively simple. Lenders will require, and borrowers are willing to pay, something for the use of funds. But lenders find that something turns to nothing when inflation begins to exceed the rate of interest at which they lend. Their reluctance to lend at a loss and the continuing demand of borrowers gives rise to market forces that operate over time to build a premium into the interest rate structure which is equal to and offsets the expected rate of inflation, leaving lenders with the prospect of some positive real return.

As may be seen in chart I, the 3-month Treasury bill rate exceeded the inflation rate consistently throughout much of the 1960's. Some positive real rate of interest has been generally characteristic of financial experience in this country—a real rate of 2 percent or so is often taken as typical. By the mid-1970's a new relationship was emerging with inflation exceeding interest rates and real rates of interest driven to negative values. Such a situation was possible since the Federal Reserve was holding down interest rates by more rapid monetary expansion than expected by investors. The danger of the policy became increasingly clear as inflation threatened to run out of control, and in October 1979 the Federal Reserve announced a new approach to the conduct of monetary policy that placed greater emphasis upon control of the monetary aggregates. Since this change in Fed policy, inflation has come down but interest rates have remained relatively high, resulting in very high real rates of interest. This shows up as a wide differential since 1979 between the two series in chart I.

It should be emphasized that the negative real interest rates of the late 1970's were a departure from normal. The strength and persistence of inflation was clearly underestimated in financial markets thereby temporarily reducing the realized real rate of return below zero. Expectations of future inflation were undoubtedly strengthened during these years. This has subsequently been reflected in the much higher real interest rates of recent years which can be viewed as a market reaction to the earlier subnormal returns.

Another factor contributing to the persistently high level of real interest rates is that the period since October 1979 has been one of much greater volatility in monetary growth and interest rates. The shift by the Federal Reserve to increased emphasis on the monetary aggregates was essential. In the broadest sense, the change in policy may be responsible for much of the progress that has been made against inflation. But the implementation of that policy—as perhaps with all policies conceived in this town—was less than ideal, and resulted in wide swings in money growth. Research at the Treasury Department suggests that the variability of money growth has added 2 to 3 percentage points to the level of interest rates over the last two years.

While interest rates are generally regarded as being excessively high there may be some question whether real interest rates are always as high as they seem. Rates which seem excessively high on a pre-tax basis are not quite so striking after tax. In the simplest possible terms, an 8-percent nominal rate of interest at a time of 4 percent inflation yields an investor in the 50-percent marginal tax bracket no after-tax real rate of return whatsoever.

From the standpoint of the consumer-borrower, after-tax real costs are somewhat higher, but chiefly because consumer borrowing costs include an allowance for risk, not present in the case of Treasury securities. For consumers, interest costs are only recently beginning to turn positive. A median income worker, for instance, whose Federal and State income tax would put him in about the 30-percent marginal tax bracket, would have had an after-tax real interest cost of about zero on a 12.9 percent, 3-year car loan taken out in late 1979. (This assumes the loan is repaid over the 3 years ending in the fourth quarter of 1982.)

A range of explanations, some of considerable complexity, have been advanced as to the current height of real interest rates. In the final analysis, however, for both real and nominal interest rates, the chief explanation of the difference between the low interest rates of the early 1960's and the high interest rates of the early 1980's is the fact of an intervening era of inflation without parallel in previous U.S. experience. In terms of aggregate economic policy, the most effective way to achieve generally lower rates of interest in the current situation is to achieve consistently lower rates of inflation.

In addition to controlling inflation, it will be very important to offer adequate incentives for saving. Real interest rates are determined by the interaction of the supply and demand for loanable funds. More fundamentally, these supplies and demands reflect the complex of motives and incentives which govern decisions to save along with the rate of return that can be achieved through capital investment. Other things being equal, policies that increase the supply of savings—such as our incentive-oriented tax reductions—will help to reduce real rates of interest.

INTEREST RATES AND THE CONSUMER

Over time, then, the general level of interest rates is determined by fundamental economic forces. These include the overall state of the economy, the resultant opportunities for profitable employment of investible funds, the savings rate, which provides those funds, and the outlook for inflation. At any particular point in time, however, interest rates for alternative investments may differ considerably, with the differences primarily reflecting the riskness of the investment or loan. The risk may have a number of dimensions, but the major element is the creditworthiness of the borrower, including the possibility of default on the loan or the difficulty that might be experienced by the lender should he need to liquidate it.

Consumer loan rates are generally considered to be administered rates. That is, they are posted by lenders rather than set by the market interaction of supply and demand conditions, such as those on Treasury securities, corporate bonds, and the like. Still, even posted consumer rates must fundamentally reflect competitive forces, especially among lending institutions.

While competition may be expected to benefit the consumer by keeping loan rates low, a number of factors cause these interest rates to be higher than those for other types of loans. Others that are testifying before your committee will be in a better position to discuss the exact mechanism by which the rates are set, but it may be nonetheless worthwhile to review briefly some of the influences that affect these rates.

One of the pressures pushing consumer loan rates up is the small size of the transactions. Outside of mortgage debt, probably the largest transaction for which consumers use credit is automobile purchase for which the amount financed is around $8,500. The average loan size for other consumer durables is less than $1,000. Clearly these loan sizes are much smaller than what could be expected for

business borrowing and consequently, the relatively fixed cost of servicing each loan is spread over a small earnings base.

Another factor accounting for the relatively high rates on consumer loans is the greater average risk of default compared, say, to that applicable to a prime business borrower. Some analysts feel that in addition to the general risk inherent in the consumer market, the Bankruptcy Reform Act of 1978, which became effective in October 1979, generated added risk to lenders by softening the impact of bankruptcy on debtors. Personal bankruptcies began to rise sharply thereafter—doubling between 1979 and 1982. With more consumers seeking relief from debt by declaring bankruptcy, the risk to and burden on lenders has understandably increased.

A further consideration in assessing consumer loans is the term for which they are written. The most publicized rates. Such as the prime, are short-term rates which are inherently much more adjustable to changing market conditions than those issued for longer periods, as is typical of consumer loans. The average term of a new car loan at a finance company was nearly 4 years in 1982; on personal loans maturities were close to 5½ years and on consumer goods about 2½ years. Therefore, it should not be considered unusual that in a transition period from high to low inflation and from high to low interest rates, consumer rates would lag more sensitive borrowing rates until there has been sufficient evidence that the current disinflationary environment is not merely a transitory stage of the economy. Bankers set their rates to include an expected inflation premium and need to be convinced that low inflation rates will continue for the duration of the loan.

Chart II displays a number of key consumer loan rates over the past decade. One obvious point that can be seen from this chart is that consumer rates are not nearly as volatile as other rates. In general the spread between those rates and the risk-free Treasury rate may be assumed largely to represent risk and the added cost of administering those small loans. In each case, the average spread between 1972 and 1977 was higher than in the period from 1978 through 1981. Even though consumer rates began to climb, they did not rise as fast as other rates did. To some extent this lag reflected the impact of State usury ceilings but it was also due to the greater rigidity of consumer loan rates alluded to earlier. Just as consumer loan rates lagged on the way up, they also lag on the way down. As other interest rates began to drop in 1982, the rate structure approached the relationships of the mid-1970's.

Presuming that the period from 1972 through 1977 represented a period in which consumer loan rates were set to grant the lender a reasonable real return, after covering costs of processing and the additional risk associated with consumer loans, it appears that in more recent years the lenders were probably caught in a squeeze that caused consumer loan rates to narrow from their traditional relationships to other rates. During the latter part of 1982 the rate structure began to be restored as market determined rates dropped sharply faster than adminstered short-term consumer rates. Consequently, spreads for the year as a whole were about back to traditional relationships with other market rates. This statement would also be true if one were speaking about such marginal cost of funds measures as CD's. At various times in 1980 and 1981 the gap between yields on CD's and consumer loans not only narrowed, but CD rates topped those on auto loans and at one point those on 24-month consumer loans. Table 1 and Chart III demonstrate more fully rate spreads over the past decade.

Brief comment may be desirable on longer-term consumer borrowing which, in practice, means mortgage borrowing. In the area of long-term finance, market and consumer mortgage rates have moved more closely. In part, this results from the secured nature of the mortgage loan, which accordingly lessens the risk of default loss. In addition, however, the market for mortgages has broadened significantly in recent years through the use of mortgage pools, FNMA activities, and the like. Thus, mortgages have acquired a degree of liquidity that allows their yields to respond to underlying economic forces in a manner more like corporate bond yields. Nevertheless, mortgage rates do tend to respond more sluggishly than other yields, and the spread of the mortgage rate over the long-term Treasury yield is currently slightly wider than has been traditional. (See Charts IV and V which show the levels and spreads between the long-term rates discussed above.)

A range of broader influences may also be important in determining the rates that consumers pay at any particular time. For example, the well-publicized losses of U.S. banks on their international lending operations may conceivably be affecting bank pricing decisions on domestic loans. Some latitude probably exists for banks to keep the gross margin on domestic loans wider than normal for brief periods of time. Bank regulators and those closer to actual bank pricing decisions may be in a position to throw some light on this and other similar issues.

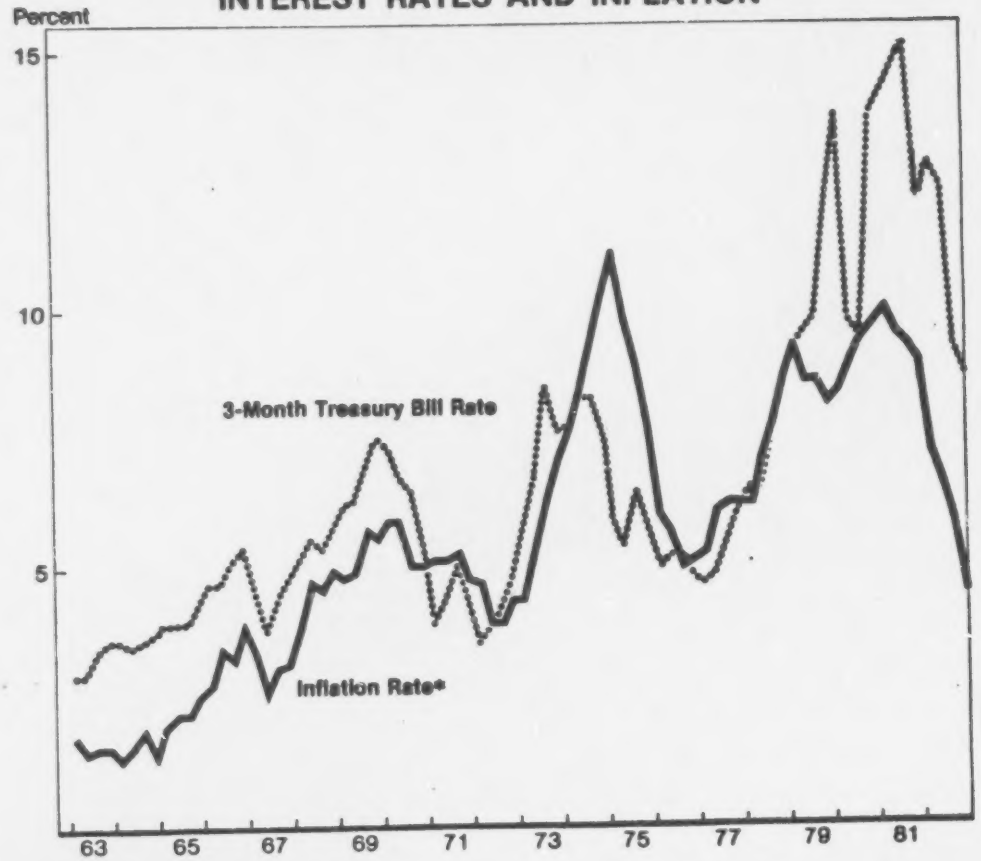
CONCLUSION

In conclusion, there appears to be no readily available evidence that consumer loan rates are somehow being set at levels that are inconsistent with the general economic environment. Stiff competition for the consumer market would prevent this. While fairly wide spreads did develop in the latter part of last year between some consumer and market rates, it is likely that these spreads are at a cyclical peak, reflecting large credit risk assessments, a volatility premium, an expected inflation rate premium substantially larger than the observed rate, and the transition to a new environment in which the average cost of funds may be higher due to deregulation. Presumably as the economy recovers and it becomes clear that inflation and market rates are stabilizing at lower levels or falling further, consumer rates will adjust downward.

In order to ensure that market rates of interest reach more satisfactory levels, we must persevere with efforts to bring inflation down and keep it down. No other single action will do more to ensure the availability of credit to consumers at reasonable rates of interest.

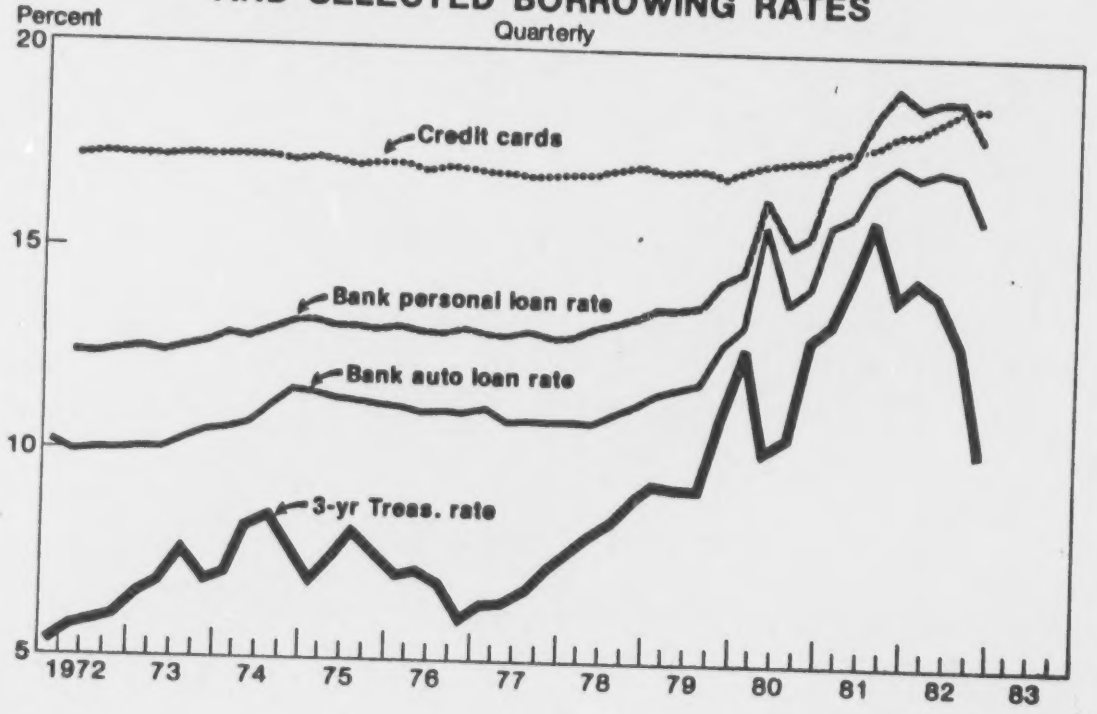
[Charts and tables accompanying statement follow:]

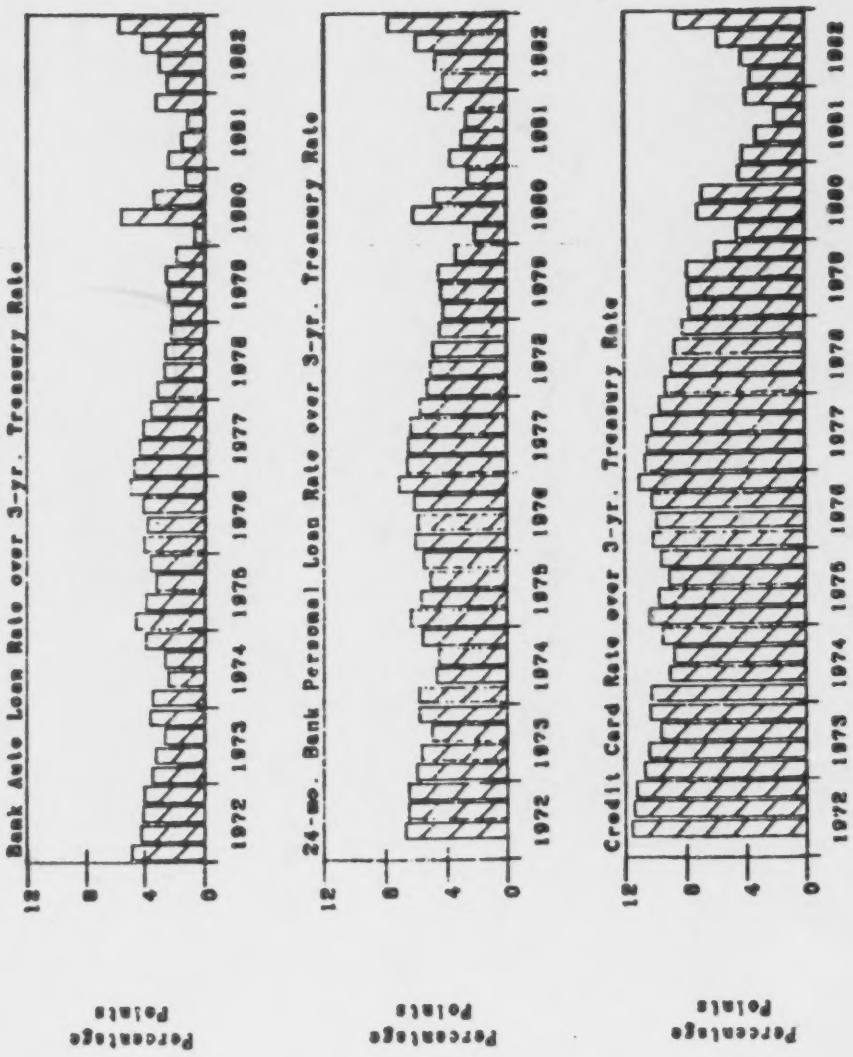
INTEREST RATES AND INFLATION

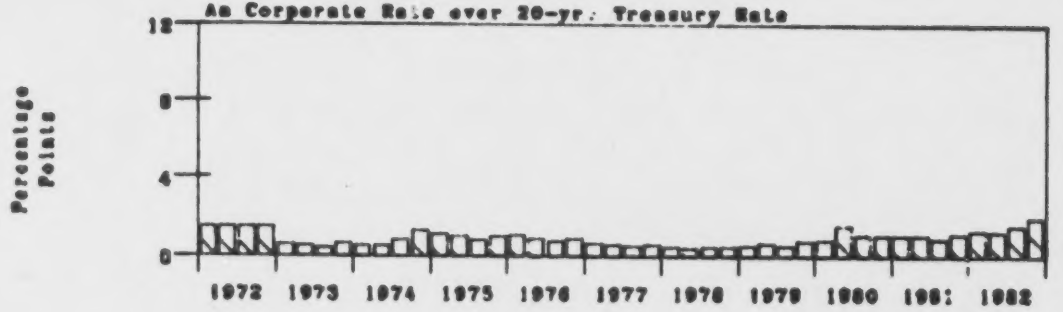


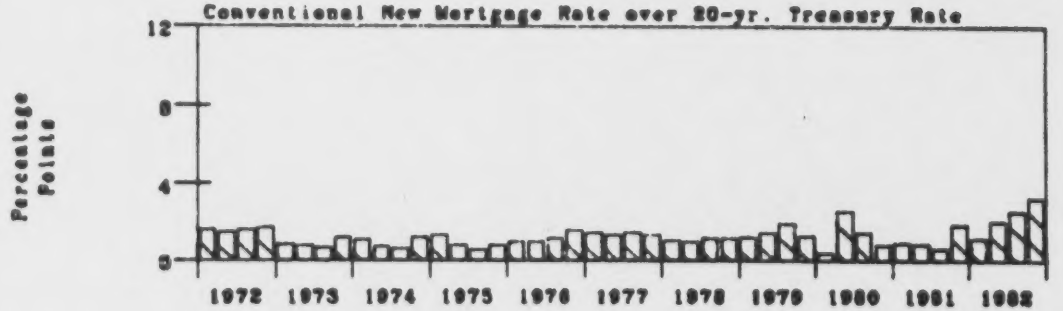
* Growth from year earlier in GNP deflator.
Plotted quarterly.

COMPARISON OF 3-YR TREASURY RATE AND SELECTED BORROWING RATES



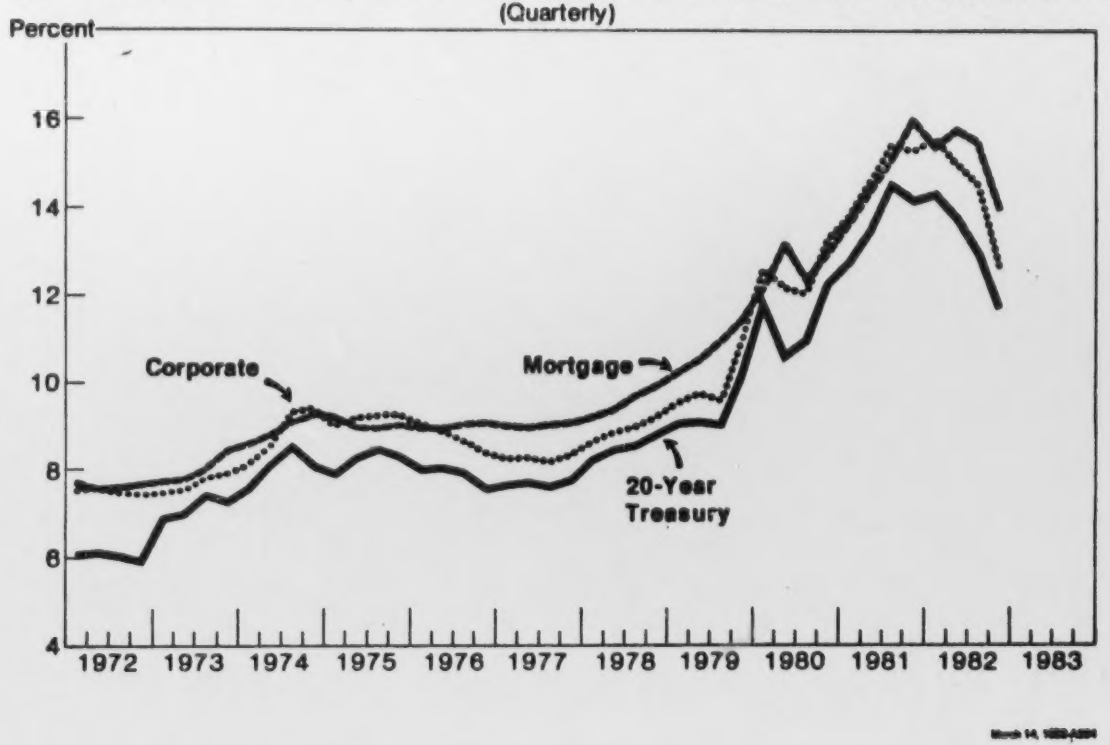

Bank Auto Loan Rate over 3-yr. Treasury Rate
24-mo. Bank Personal Loan Rate over 3-yr. Treasury Rate
Credit Card Rate over 3-yr. Treasury Rate
Percentage Points
12
8
4
0
1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982


Aa Corporate Rate over 20-yr. Treasury Rate
Percentage Points
12
8
4
0
1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982


Conventional New Mortgage Rate over 20-yr. Treasury Rate
Percentage Points
12
8
4
0
1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982

COMPARISON OF 20-YEAR TREASURY, HIGH-GRADE CORPORATE BOND, AND CONVENTIONAL MORTGAGE RATES

(Quarterly)



Spreads Between Consumer Loan Rates and
Other Market Rates of Interest

	Commercial Banks			Finance Companies*		
	Auto loans (36-month)	24-month personal loans	Credit card plans	Auto loans	Personal loans	Consumer goods loans
	Difference from 3-Year Treasuries (percentage points)					
Annual averages						
1972-77	3.9	5.9	10.1	5.7	13.9	12.4
1978-81	2.5	4.2	6.3	3.3	10.0	9.1
1982	3.9	5.7	5.6	2.9	10.2	9.6
Quarterly						
1982: I	2.6	4.3	3.6	3.2	8.4	8.8
II	3.1	4.8	4.3	0.6	8.8	8.6
III	4.2	6.1	5.9	5.0	10.3	9.5
IV	5.8	7.8	8.6	2.7	13.2	11.6
	Difference from 3-Month CD Rate (percentage points)					
Annual averages						
1972-77	4.0	6.1	10.4	5.9	14.1	12.5
1978-81	1.4	3.1	5.2	2.2	8.9	8.0
1982	4.6	6.4	6.2	3.5	10.8	10.3
Quarterly						
1982: I	2.8	4.5	3.9	3.4	8.7	9.1
II	3.0	4.7	4.2	0.5	8.7	8.5
III	5.5	7.3	7.1	6.3	11.6	10.8
IV	6.9	9.0	9.7	3.8	14.3	12.8

* Terms on loans at finance companies generally lengthened over the period.

3/15/83

19-096 O—83——3

Senator HAWKINS. Thank you, Mr. Johnson.
Mr. Martin.

STATEMENT OF PRESTON MARTIN, VICE CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. MARTIN. Thank you, Madam Chairman. I appreciate the opportunity to appear before you and to discuss the weighty issues that relate to consumer interest rates in this country.

I certainly would join with others who commend you and members of this committee for addressing this issue at this time. The increased spending of consumers, and the increased borrowing that goes with it, is, of course, a vital factor in the economic recovery which appears to have begun but which is giving many signs of weakness relative to other recovery periods since World War II.

I support your statement that consumer interest rates are important in the markets for automobiles, homes, durables, and other goods and services. Consumer surveys have to be taken with a good deal of skepticism, nevertheless, numerous surveys seem unanimous in indicating that, when wary, the consumer will indicate his or her perception that interest rates are high and that the very level of rates constitutes a constraint on additional consumer borrowing. You see statements like, "I would be willing to pay 11 percent and they are asking 15, 16, or 14 percent." So certainly interest rates are an important constraint at this time.

It's not the only constraint, as the committee is well aware. Unemployment, under-employment, and the need for large numbers of people to change their geographical location to continue to support their families have held down borrowing and spending. Additionally, the drum fire of news stories with regard to international difficulties, questions raised about social security availability when one retires, plant closings and the bankruptcies that have been alluded to, have all been a factor in the consumers' slowness to come back into the markets, particularly the markets for durables.

I have been talking primarily about the demand side of consumer credit markets. Obviously, the supply side differs from the supply side of funds for other purposes, but I will economize on the committee's time by omitting those portions of my testimony which have been well covered by my fellow panelists.

FOREIGN LOAN LOSSES

On the question of foreign loan losses and the provision for losses, I don't disagree that this is one factor, among many others, in the slowness with which commercial banks—I'm not talking about finance companies, savings and loans, and so forth—have lowered their consumer loan rates. As the chairman has indicated, there are areas and kinds of consumer credit where rates actually have gone up. If you take the macro approach and look at consumer credit pricing across the country, there has been a slowness in adjustment. Partly, this is to be expected. There generally is some lag time, a lag that one can see when one plots consumer credit charges excepting for credit cards—installment loans, second mortgage loans, consolidation of debt loans, and other segments. There is always a lag.

The question really is, can we say this is an undue lag? I still don't know the answer to this question, after going through a rather extensive review of the data in recent weeks. Maybe it is. There's always a lag in this response.

I would add to the foreign loans, though, particularly for the small banks, the obvious need to provide for agricultural lending delinquencies. We are at a most unfortunate time in the history of agricultural operations in this country. The young farmer who a few years ago went out and bought extensive acreage on credit, on a variable rate loan, and who took production credit and equipment credit and on and on, now finds himself in situations where commodity prices have plummeted and aggregate output is enormous. Storage has become a problem, and the interest rates, while having come down on some of those variable loans, are still quite high.

That kind of loan problem is hitting particularly the small banks in rural areas. And then there's, of course, the whole panoply of energy-related lending that has to be rethought and loss provisions made. So I don't stop at the foreign loan situation in considering this lending environment.

I would like to reinforce a comment made earlier with regard to the secondary market. Some of us have worked with you and your staff, and with some of your fellow Senators, for many years in the secondary marketing for mortgage loans. We are pleased with the cooperation shown over the years, and with the depth and extent of the secondary market that has developed. I wonder if there has been sufficient consideration of measures that would further the secondary market for consumer "paper." As has already been explicated here, the ability to originate, service, and resell consumer paper would tend to bring down the rate.

As we all know, the relatively high consumer rates are built up from so many factors—only starting with the cost of money which, of course, is extremely high for many of these institutions, particularly small ones.

SMALL BANK PAYS MARKET RATES

The small bank now has to pay market rates—the rates on money market deposit instruments, and Super-NOW accounts. For the small bank there no longer are "free deposits." The disappearance of the passbook and the shrinking of the good old demand deposit, of course, means that for the small banker or medium size banker or regional banker, costs are going up. And on top of the cost of funds, there are other major considerations in consumer credit—administrative costs and default ratios, credit losses, and the lack of a secondary market.

That small banker can originate an FHA loan, sell it and get the net revenue from servicing. To a larger extent, I'm happy to say, he can originate a conventional loan and sell it. Well, of course, we have witnessed the impact of the secondary market on mortgage rates. There's a huge volume of GNMA securities coming out, backed by pools of FHA/VA mortgages. As FNMA and FHLMC have gone into swap and conduit programs, involving large amounts of conventional loans, falling capital market rates, of

course, also have meant falling mortgage rates. The last quote from FHLMC, my old institution, indicated that rates on conventionals that they were dealing with had reached a 32-month low.

So I wonder if there's been enough consideration in the industry, in the regulatory agencies and elsewhere, with regard to the potential of secondary market facilities and, if you will, purchases and sales of consumer loans.

The recent movement in capital markets rates, of course, is not why we are here, and it was rightly brought out in your opening statement that there is a most encouraging potential on the cost side of originating and servicing consumer credit. The increasing trend toward personal computers, small computers with small capacity, has begun, particularly this last year, to open up the potential of automation to the small institution. I'm sure we're all aware that it is the small and medium size banks and other kinds of institutions that are most heavily in the so-called retail market. We are not talking about money center banks here so much as we're talking about a regional or so-called community bank, a bank with $50 million or $500 million in assets; in the banking world with inflation, of course, such an institution is not quite as large an element as it used to be. The automation potentials are substantial.

BANK CREDIT CARDS

Cost reduction seems most problematic in the bank credit card function. Our investigation into these costs indicates that many of even the medium size banks have largely automated their credit card operations. Yet they still are sustaining losses on a profit-center basis on that part of their consumer credit portfolio—not in the lending which is secured, not on auto loans or loans on durables and furniture and so forth, but in the unsecured part, the so-called plastic money. It's very difficult for the small bank, even for those that have gotten into the use of computer facilities and so-called intelligence terminals, to make money on credit cards.

I'm encouraged by the increased savings and loan entry into consumer credit markets. I believe that over time this will tend to bring down consumer loan rates. Of course, we all live in the short run, so when we talk about "over time", that phenomenon is not enough to sustain a recovery in the next quarter or even three, four, five, or six quarters. But data is beginning to show a substantial entry by savings and loans in this area. It is slow, of course, because savings and loans that have not had a big consumer loan department have to staff for it. You can't underwrite consumer credit the way you underwrite mortgages, as I found out in the private mortgage insurance business—which now is taking some pretty heavy losses. But the savings and loans are entering these markets, and that's going to bring rates down.

Of course, the outlook is so much a function of what is done within these halls with regard to future deficits; with regard to further progress that we all hope and even pray for in promoting disinflation. Success in the fight against inflation will mean that one component of this big interest rate on consumer credit—the allowance for inflation, the uncertainty about inflation, the risk premium that's added on top of the rising cost of funds for the small in-

stitution—will tend to come down to more normal levels. But these lenders are skeptical, and it's understandable that they're skeptical. We've had a year or two of progress, but that's following a decade of inflation, and the wage bargains that are going on and will go on, the actions of the Congress in the fiscal area, and the actions of the Federal Reserve System in the monetary area, are factors that a lender and a borrower must take into account.

These borrowers are confused, and it's not only the high rate, the confusion about inflation and what you and we are going to do about it that is a factor. Market confidence in the success of fiscal policy and monetary policy has to be supported by continued commitments and decisions both in the Congress and the Administration, to reduce the structural deficits and maintain confidence in monetary policy. Then the recovery can be sustained on the basis of growth of household purchasing power in real terms, in concert with increasing strength in other economic sectors.

Thank you for your courtesy.

[The complete statement follows:]

Statement by
Preston Martin
Vice Chairman, Board of Governors of the Federal Reserve System

Madam Chairman, I appreciate the opportunity to appear before this Subcommittee on behalf of the Federal Reserve to discuss consumer interest rates. I feel that the Subcommittee has adopted a very appropriate focus on consumer finance at this early stage in what is expected to be a "consumer-led" recovery. Increased purchases by households of homes, autos, durables, and other goods and services, if sustained, will tend to induce merchants and manufacturers to restock inventories, increase production, and eventually hire and rehire those who are suffering unemployment and underemployment.

Interest rates are important to the consumer. Various public opinion polls have indicated that shoppers consider interest rates to be quite high and that postponement of purchases often is attributed to rates which exceed what the consumer thinks is acceptable. Recent surveys of consumer attitudes indicate that many shoppers for credit are willing to pay around 11 percent to finance purchases. At the same time, as you are well aware, the merchant or lender generally requires rates of 14 percent or more.

Of course, interest rates are not the only constraint on increased spending by households. Unemployment is very high and the pronounced slowing of inflation has removed much of the motivation for "hedge buying." House prices in some areas have declined and mortgage refinancing may be costly. Saving looks more attractive via the higher returns offered through new money market deposit accounts and the tax advantage offered by more liberal IRA and Keogh account provisions.

Given the present environment of a modest and uncertain recovery, consumer interest rates could play a major role in ensuring that the recovery will be a sustainable one. Interest rates on most forms of credit used by

consumers have been coming down recently, and further declines apparently are in train for some types of loans. The dimensions of the declines we can look forward to differ for various types of loans--partly because of the characteristics of particular markets, differences in administrative costs, and the extent to which the earlier upward rate movements had been constrained by usury ceilings. Because of the nature of the markets involved, consumer loan rates have typically fluctuated less widely than other rates in response to changes in cyclical movements of the economy, and I believe there is nothing particularly unusual in the recent patterns of interest rate movements. Some say that the pricing of consumer and other loans by some institutions may reflect some caution by institutions with respect to potential loan losses in foreign, agricultural and energy related credit. However, it has been our experience that present-day credit markets generally are too competitive and too fluid for lending institutions to extract excessive profits in any given market over any significant period of time.

Nevertheless, it is true that rates have come down on some kinds of consumer credit less than business loan rates or the rates on Treasuries. Short-term market rates generally are 9 to 10 percentage points below their earlier peaks; long term market rates are lower by 4 to 5 percentage points. Mortgage rates are the exception among consumer finance rates; the Federal Home Loan Mortgage Corporation quotation of 12.79 percent on conventional home loans last week was nearly six percentage points below the peak in 1981.

Mortgage rates, of course, are a good deal more closely tied to market rates than is true for other types of consumer credit, thanks to the increasing use of mortgage-backed securities and the secondary mortgage

market. Those who originate mortgages more and more are a different group from those who invest in them. Installment loans, revolving credit and other consumer credit forms generally have no true secondary market, and thus rates tend to be "sticky" relative to open-market and mortgage rates. Some loan originators sell the consumer "paper" they originate, but these tend to be bulk sales to a commercial bank or some other buyer, not to capital market investors. Thus the majority of installment and revolving loans are held in the portfolios of the originators. The very marketability of the mortgage loan may result in a lower rate compared to a largely nonmarketable consumer credit contract.

An additional factor is that mortgage loans are much larger, on average, than other types of consumer credit. The Federal Home Loan Bank Board's February data indicated conventional 75 percent-of-value loans ranging from about $42,000 in Pittsburgh to around $108,000 in the San Francisco area. Other than mobile home chattel mortgages, most consumer loans are for amounts ranging from a few hundred dollars to something like $10,000. Thus the mortgage lender can spread his costs of loan origination, servicing, and collection over a larger base. Faced with somewhat similar administrative costs and higher collection or servicing outlays, the supplier of consumer credit tends to need a higher percentage rate of interest.

Recent Behavior of Consumer Interest Rates

What factors explain the relative insensitivity of consumer rates to the dramatic decline in other rates in recent months? Households borrow funds primarily in three forms that are, to some extent, substitutes for each other. These forms are consumer installment loans, open-end or "revolving" credit-card plans, and mortgage loans collateralized by homes. Movements in

interest rates on these types of borrowing have differed considerably in recent periods. Changes among the various rates paid by households, and movements in consumer rates relative to other rates have largely reflected two factors: the degree of credit market segmentation, and the impact of artificial constraints on rate movements in the consumer-oriented market sectors.

As mentioned, home mortgage rates have come down about in line with other long-term market yields. Federal Reserve data on consumer finance rates, however, show a mixed pattern. In early February, average consumer finance rates (APR) at reporting banks were down from peak levels, as follows: new auto loans, down 2.55 percentage points;[1] mobile home loans, down 1.70;[2] other consumer goods and personal expenditures, down 1.62 points.[3] Average rates on bank credit card plans rose in February 1983 to a level of 0.75 percentage points above February 1982. Table 1 contains the relevant data.

Consumer installment loans. The reductions in rates on consumer installment loans, to be sure, have been modest when compared with other types of interest rates. Spreads between installment loan rates and the bank prime lending rate have risen since the middle of last year, and much the same pattern is evident when comparisons are made with CD rates at banks or with yields on Treasury securities having maturities comparable to those for consumer loans. However, these various yield spreads--while relatively large--are not out of line from spreads that emerged during the 1970s.

It should be stressed that the recent increases in spreads between installment loan rates and other yields followed substantial reductions in

1. 36 months maturity.
2. 84 months maturity.
3. 24 months maturity.

spreads that occurred as market interest rates climbed during the 1977-81 period. This pattern, also evident during earlier interest rate cycles, suggests that recent movements have mainly reflected fundamental market mechanisms.

There are several reasons why rates on consumer installment loans tend to lag movements in open-market rates of comparable term, and to move over a narrower range during the cycle. As interest rates peak, state usury ceilings may limit upward movements in consumer loan rates, encouraging lenders to tighten nonrate loan terms and lending standards. Subsequently, when market yields decline, lending terms and standards tend to ease first, followed by downward adjustments in consumer loan rates. It is clear that interest rate ceilings in various states constrained upward movements in installment loan rates to some extent in 1981-82, even though many states adjusted their statutes and federal law enacted early in 1980 provided a limited preemption of state limits for all federally insured depository institutions.

In addition, the sluggish movement of consumer loan rates also is attributable to the imperfections in the linkages between consumer credit markets and other components of our credit system--as I noted earlier. Imperfect linkages to the general capital markets, of course, do not imply that individual lenders can maintain consumer loan rates far out of line from those prevailing at other institutions in their local markets. Although households may not shop as intensively for rates on short-term consumer loans as they do for rates on large and long-term home mortgage loans, competition in the primary markets for consumer loans is increasing.

In support of that thesis, there is evidence that savings and loan associations, a relatively new entrant in many of these functions, are

currently expanding their nonmortgage portfolios to put the MMDA and Super-NOW dollars to work. They are fast becoming a factor in the growth of consumer installment credit. In January of this year, savings and loans increased their participation in the consumer installment credit market at nearly a $5 billion annual rate, and they increased their credit outstanding by 22 percent over the 12 months ending in January.

Bank credit cards. Although rates on closed-end consumer installment loans have been declining, albeit sluggishly, average interest rates on bank credit-card plans actually have continued to rise. The behavior of average rates on credit card plans has been strongly influenced by state ceilings on the rates that banks may charge cardholders on outstanding balances.

While rates on closed-end installment credit at banks climbed by about 6 percentage points during the 1978-81 period, and those on open-market investments rose still more, average rates charged consumers on bank credit-card plans rose only about one percentage point as most states maintained interest rate ceilings of 18 percent or less. Under these conditions, of course, banks resorted to other ways of passing on the rising cost of their card plans as the profitability of this function plummeted. Many institutions imposed annual fees on their credit cards and also raised their merchant discounts--i.e., the percentage deducted by the bank from the face amount of receivables purchased from retailers.

Increases in average bank credit-card rates during the past year reflect upward adjustments to rate ceilings by some states, and shifts of credit card operations by some banks to states with higher ceilings or with no ceilings at all. States like South Dakota and Delaware became the haven

for the credit card operations of a number of large banks located in states with more restrictive interest rate limitations.

Outlook for Consumer Loan Rates

Further movements in interest rates on home mortgages will depend primarily upon developments in the markets for longer-term debt instruments generally. Average rates on credit-card accounts may continue to be influenced, at least in the short run, by changes in usury statutes and by interstate shifts of credit-card operations by banks seeking to bolster the profitability of their plans; increases in rates associated with these factors, of course, may be accompanied by downward adjustments in annual card fees and merchant discounts. With respect to closed-end consumer installment loans, average interest rates could fall somewhat further in the near future. If so, this would reflect the usual lagged adjustment of these loan rates behind movements in yields on market instruments. In this regard, it is noteworthy that nearly half of the banks routinely surveyed by the Federal Reserve last month indicated greater willingness to make consumer installment loans than three months earlier.

Further reductions in the entire structure of interest rates in the economy will depend critically upon progress against inflation and positive developments on budget deficits. Remarkable progress against inflation has been made during the past year, and favorable conditions in markets for oil and basic food commodities bode well for the near future. As inflation has come down, so have market interest rates. However, interest rates across all markets remain high relative to the current rate of price inflation particularly on longer-term instruments. This suggests that expected rates of future price inflation, which profoundly effect nominal interest rates, remain well above current actual inflation rates.

Such skepticism is understandable. A year or two of progress, following more than a decade of rapid inflation, is not enough to quell fears that prices will accelerate again as the economic recovery proceeds. And it is widely anticipated that we will see a return to aggressive wage bargaining and price setting if it appears that inflation is being permitted to accelerate once again. The current situation is fragile, and it is clear that the major test of the sustainability of our anti-inflation effort lies ahead.

The Federal Reserve remains committed to policies that will permit the economy to expand without regenerating inflationary pressures, and adherence to this course should lead to lower interest rates over time. There are, however, some obstacles along this path. In particular, the prospect of huge Federal deficits looms ahead even as the economy expands; that is, the "structural" deficit promises to remain very large even as the "cyclical" deficit declines. That expectation is widely held in the financial markets and by the public at large, and the prospect of intensified public sector "crowding out" of private demands for the available supply of credit appears at least partly responsible for the maintenance of high "real" interest rates on longer-term instruments. Fears abound that the large deficits will not only place heavy demands on the credit markets but that they will thereby create pressures for excessive monetary expansion, causing the battle against inflation to become considerably more difficult.

Clearly, the fundamental outlook for interest rates does not lie, primarily, in the hands of the Federal Reserve alone. Market confidence in the success of monetary policy must be supported by the continued commitments and decisions in both the Congress and the Administration to reduce the large structural federal deficits that threaten to place heavy pressure on our financial resources as the economy picks up speed. Complementary monetary and fiscal policies will foster the easing of inflationary expectations essential to sustained reductions in rates on consumer loans and other types of credit. Then the recovery can be sustained on a basis of the growth of household purchasing power in real terms, in concert with increasing strength in other sectors.

TABLE 1

MOST COMMON FINANCE RATES (APR) ON DIRECT CONSUMER INSTALLMENT LOANS
AVERAGES AT REPORTING COMMERCIAL BANKS

Date	New auto (36 month)		Mobile home (84 month)		Other consumer goods and personal expenditures (24 month)		Credit card plans	
	Finance rate (percent)	Change (basis points)	Finance rate (percent)	Change (basis points)	Finance rate (percent)	Change (basis points)	Finance rate (percent)	Change (basis points)
1972 - Feb.	10.20		10.88		12.50		17.13	
May	9.96	-24	10.73	-15	12.44	-6	17.24	11
Aug.	10.02	6	10.71	-2	12.47	3	17.25	1
Nov.	10.02	0	10.85	14	12.44	-3	17.23	-2
1973 - Feb.	10.05	3	10.76	-9	12.51	7	17.16	-7
May	10.05	0	10.84	8	12.48	-3	17.22	6
Aug.	10.25	20	10.95	11	12.66	18	17.22	0
Nov.	10.49	24	11.19	24	12.75	9	17.23	1
1974 - Feb.	10.53	4	11.25	6	12.82	7	17.24	1
May	10.63	10	10.96	-29	12.88	6	17.25	1
Aug.	11.15	52	11.71	75	13.11	23	17.17	-8
Nov.	11.57	42	11.87	16	13.16	5	17.16	-1
1975 - Feb.	11.51	-06	12.14	27	13.20	4	17.24	8
May	11.39	-12	11.57	-57	13.11	-9	17.21	-3
Aug.	11.31	-8	11.80	23	13.05	-6	17.14	-7
Nov.	11.24	-7	11.76	-4	12.96	-9	17.06	-8
1976 - Feb.	11.18	-6	11.77	1	13.02	6	17.14	8
May	11.01	-17	11.61	-16	12.96	-6	17.02	-12
Aug.	11.07	6	11.84	23	13.02	6	17.01	-1
Nov.	11.02	-5	11.77	-7	13.06	4	17.04	3
1977 - Feb.	11.14	12	11.83	6	12.95	-11	16.89	-15
May	10.81	-33	11.73	-10	13.00	5	16.87	-2
Aug.	10.86	-5	11.89	16	12.87	-13	16.86	-1
Nov.	10.86	0	11.91	2	13.06	19	16.92	6

TABLE 1

MOST COMMON FINANCE RATES (APR) ON DIRECT CONSUMER INSTALLMENT LOANS
AVERAGES AT REPORTING COMMERCIAL BANKS

Date	New auto (36 month)		Mobile home (84 month)		Other consumer goods and personal expenditures (24 month)		Credit card plans	
	Finance rate (percent)	Change (basis points)	Finance rate (percent)	Change (basis points)	Finance rate (percent)	Change (basis points)	Finance rate (percent)	Change (basis points)
1978-Feb.	10.86	0	11.92	1	12.94	-12	16.90	-2
May	10.84	-2	12.01	9	13.11	17	16.97	7
Aug.	11.09	25	12.16	15	13.30	19	17.10	13
Nov.	11.29	20	12.18	2	13.42	12	17.16	6
1979-Feb.	11.60	31	12.37	19	13.59	17	17.05	-11
May	11.73	13	12.54	17	13.65	6	17.06	1
Aug.	11.88	15	12.65	11	13.76	11	17.09	3
Nov.	12.85	97	13.51	86	14.39	63	16.93	-16
1980-Feb.	13.28	43	13.57	6	14.69	30	17.13	20
May	15.72	244	15.96	239	16.31	162	17.31	18
Aug.	13.91	-181	14.95	-101	15.33	-98	17.39	8
Nov.	14.29	38	15.49	54	15.54	21	17.41	2
1981-Feb.	15.84	155	16.58	109	17.14	160	17.58	17
May	16.04	20	17.02	44	17.48	34	17.71	13
Aug.	16.92	88	17.89	87	18.52	104	17.78	7
Nov.	17.36	44	18.29	40	19.21	69	18.04	26
1982-Feb.	17.05	-31	17.98	-31	18.76	-45	18.14	10
May	17.20	15	18.23	25	18.90	14	18.41	27
Aug.	17.08	-12	18.43	20	18.93	3	18.73	32
Nov.	15.97	-111	17.55	-88	17.99	-94	18.75	2
1983-Feb.	14.81[1]	-116	16.73[2]	-82	17.59	-40	18.89	14

Note: Finance rates are annual percentage rates as specified by Regulation Z (Truth-in-Lending). They apply to the "most common" rate charged on the largest dollar volume of loans in the particular credit category during the first full calendar week of the month.

1. 48 month maturity beginning in 1983.
2. 120 month maturity beginning in 1983.

Source: Federal Reserve

Senator HAWKINS. Thank you, Mr. Martin.

At this point I'd like to have Mr. Sweet, who's an economist on my staff, explain these charts that are here and I would like to have a comment from the panel on these charts.

Mr. SWEET. This first chart represents the observations that the Senator asked us to put together from data submitted by the Federal Reserve Board. The broad conclusion that we reached from the evidence is that indeed the spread between the prices being charged consumers and the amount that institutions are paying for funds is indeed much higher than the historical rates that we have experienced over the post-war period and for the most immediate 6-year period.

For example, the credit card rate we found since 1981 is actually going up at a time when the cost of money represented by the 3-month CD rate actually is dropping sharply. Thus, the difference between this line and this line (indicating) represents in some sense a gross margin from which operating costs and loss reserves would be subtracted to determine net profitability, and it is at very high levels and perhaps still growing.

Similarly, this other line represents the loan rates charged for 12-month installment credit. Perhaps if you were going to buy a washer or a dryer or some consumer durable, this would be the rate that you would be charged for that purchase.

We have the same analysis and this represents the spread between what the institutions are basically paying for money and what they're charging. This, too, is quite high.

Another way of demonstrating the same sort of historical factors at work here is to reproduce this on a bar chart and this chart represents the cost of money subtracted from the rates being charged on auto loans. This is an especially important area of finance because it represents 40 percent of all the monies that are lent to consumers to go to new cars. When we took the last 41 quarters of observations and plotted this, what we found is as follows: roughly two percent of the time the rate is as high as 7 points. That is the difference between the cost of money and the rates being charged consumers was 7 full points. 30 percent of the time it has been as low as one point.

We are right now at a 6 point spread. Another way of putting this is that 85 percent of the time the spread has been lower. So historically, we are dealing in a very high phase. If you were to take a 10-year average of this since 1972 to 1982 and look at this, what you would find is that the spread had historically been about three points. Thus, one could conclude that if the historical rates now were prevailing, the rates for new car loans would not be 15 percent, they would be 12 percent.

[Copies of charts referred to follow:]

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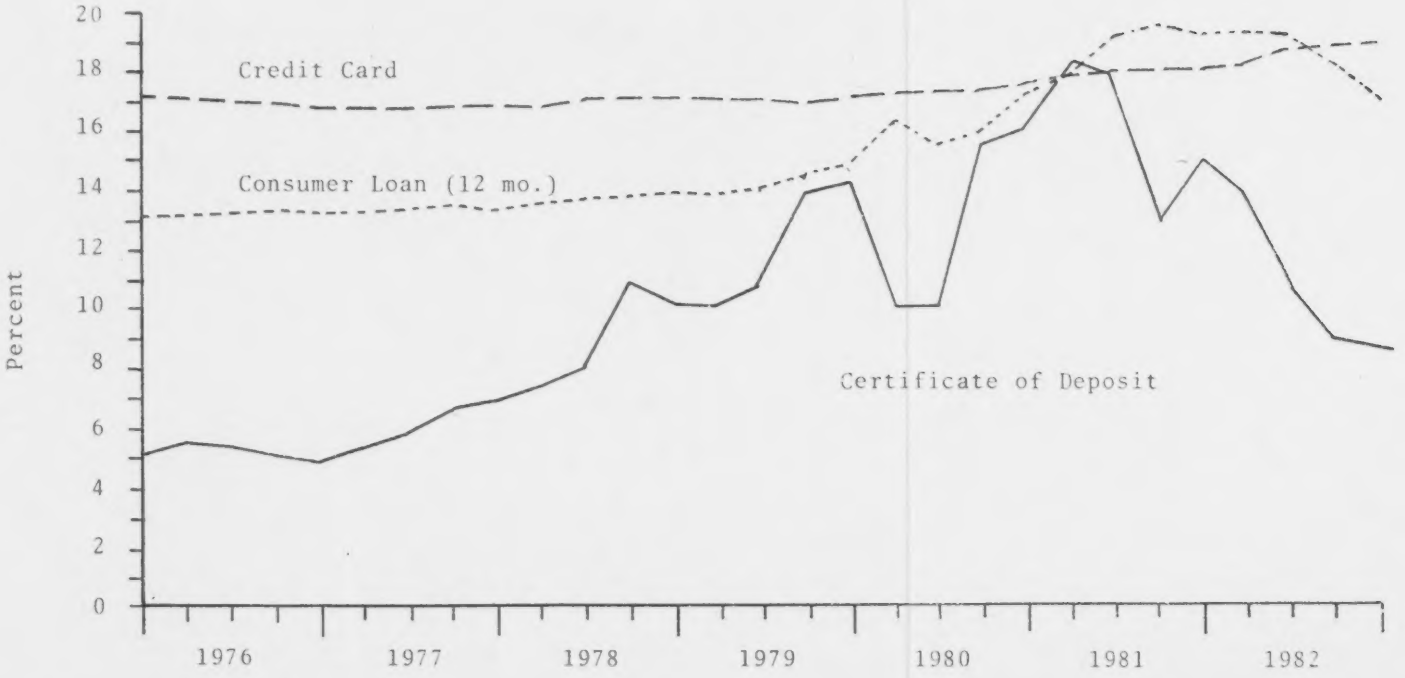
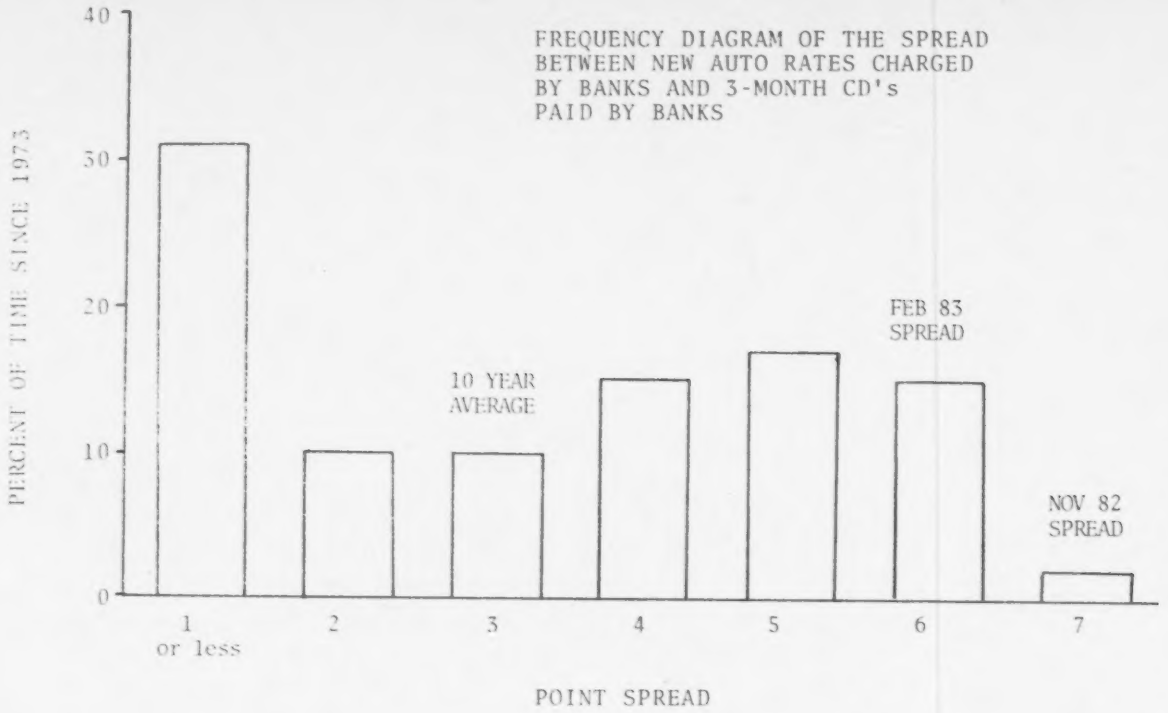
BANK CONSUMER LOAN AND CERTIFICATE OF DEPOSIT RATES



Source: Board of Governors, Federal Reserve System



SOURCE: BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Senator HAWKINS. Thank you. Mr. Poole.

Mr. POOLE. I guess you could tell that I was dying to make a comment.

I think it's important when you make these comparisons to make them for financial instruments of the same maturity. There is a gap at the present time between, let's say, the CD rate or three-month Treasury bill rate and longer paper. Long-term interest rates are higher than short-term interest rates. So part, but only part, of the explanation of that chart is a comparison of—I'm talking about the 3-year auto loan rate first—with the short-term CD rate.

That's the reason why my own chart, which is chart 1 in my statement, compared the 36-month auto loan rate with a 3-year Treasury security rate.

Now, as you can see from my chart, there is a substantial differential. I'm not saying that the phenomenon I'm discussing ——

Senator HAWKINS. However, we did use the short-term. We used the 12 months. That's the short-term for the consumer loan.

Mr. POOLE. Right. I agree on the credit card loan and on short-term consumer loans, but when we're talking about auto paper it's important to understand that we've got the maturity issue here and we just want to make sure the comparisons are on the same maturity basis. That was the main point I wanted to make about that comparison.

Senator HAWKINS. Since 40 percent of the money lent is for cars, that seems to be a big factor in recovery of both the manufacturing and the selling of automobiles that is so important to our economic recovery.

AUTO SALES RESPOND TO LOW RATE FINANCING

Mr. POOLE. Absolutely, and I think it's interesting to see how auto sales have seemed to respond to the lower rate financing that has been offered by some of the auto companies.

Senator HAWKINS. Is that really a lower rate or do they add it to the price of the car?

Mr. POOLE. Well, I think what happened was that the auto companies had used various different promotions in order to move cars in the last year or two and sometimes they used promotions in the form of rebates, which is most directly in the price of the car itself. More recently they have used low rate financing. So one is to some extent a substitute for the other, and it does seem that there was a substantial response to the cut in the auto loan rate which I think is reinforcing your point that these rates are important. I certainly don't disagree with that at all.

Senator HAWKINS. Mr. Johnson, do you have a comment?

Mr. JOHNSON. I have comments very similar to Mr. Poole's. I would say the same thing about comparing instruments of similar maturity. Although you have comparable maturity dates for consumer loans, I think one point needs to be made with respect to the chart and the bar graph. I think one reason why the spread was so narrow over this time period is probably because we were in a high inflation environment and the small spread was due to the lag in adjusting these consumer loans to higher inflation rates. Therefore,

we had a long period where the lender was taking a beating because they weren't adjusting their loan portfolios fast enough to account for inflation.

I think that what we have now is probably a return to more historical norms where we are in a period of relatively lower inflation and there's a lag effect in further downward adjustment to the underlying inflation rate, but that will come as inflationary expectations are permanently lower.

Senator HAWKINS. Mr. Martin, do you have a comment?

Mr. MARTIN. Madam Chairman, I would only comment, with regard to the frequency part of the vertical bar chart, that I think that is data which we all should be aware of. I wish I could assure the chairman that the drop of 100 basis points in the spread in 3 months would be repeated over the balance of this calendar year, so that we would get to the 10-year average in three more quarters. But I'm not sure that that favorable move is indeed what to expect.

In terms of the 100 basis point spread in the frequency diagram, I'm not sure that that is sound lending by commercial banks. I will have to be a bank supervisor here for a minute and say that I wonder if, in looking at a portfolio with over a 100 basis points spread—admittedly, it's an inflationary time and there's a lag in bringing the rates up and so forth—but I wonder if that's enough to set aside adequate reserves in such an important kind of lending.

In terms of your question about whether the dealer adds the interest rate subsidy onto the price of the car, I think that is a very good question to raise. I think some of them do it when they can. As far as the way that the car manufacturers deal with the dealer network, they in many cases require the dealer to cut to zero, or cut in half, the payback that a dealer gets from his financial institution—for example, GMAC—for arranging the financing. And so there's pressure on the dealer to raise that price.

I wonder, though, in today's auto market, with the competition of foreign products, whether he could do it or not. I'm sure he would like to, but I'm not sure that you can do that against the foreign competition. Here I'm talking about American manufacturers of American products.

Senator HAWKINS. Mr. Martin, do you feel that a domestic borrower rather than the commercial should have to bear the burden of a bad foreign investment, a management decision made to a foreign country, rather than the stockholders of the bank?

Mr. MARTIN. I think I go along with the last part of your statement. I think stockholders of banks, many of them, are aware that profitability will be affected by some loan losses overseas, but I guess I'd want to add again that for most commercial banks—take the 14,000 commercial banks—most of them are looking at reduced profitability from domestic lending. It isn't foreign lending that's affecting most banks, and I suppose the rate of return on equity is running 10, 11, 12, or 13 percent, which is not all that high compared to for example, a Standard & Poor's universe of corporations. It is not an unduly high rate of return on equity for 1982, and I would think that those returns would be a mixture of a recovering economy, so there are higher revenues, and a need to make further

allowances for these loans. I don't know where I come out on this. It is a conficting flow of good news and bad news.

Senator HAWKINS. It's a puzzlement, as they said in "The King and I."

Mr. JOHNSON. I'd like to make a point if I may. I think that as I mentioned in my statement, the banks really can't spread these costs of bad management decisions, in terms of international loans, over their entire portfolio for very long or, if they do, they will simply have to bear the cost of losing market share to competing banks who made better decisions and can offer loans at lower rates because they don't have those risks associated with their portfolios.

I don't think that consumers can be affected by these international problems for very long. If an attempt is made to shift loan losses to consumers, I think that other banks, since this is such a competitive industry, will be able to offer loans at lower rates and attract those borrowers.

Senator HAWKINS. Isn't that the very reason we have competition, so some banks can offer lower interest rates?

Mr. JOHNSON. Yes.

Senator HAWKINS. And there really is competition. The way all three of you speak today, you talk about prime, and it seems to me there really is no competition and everybody operates off the prime. Now you're saying that a bank can't absorb the cost of a bad loan because they would no longer be competitive in a very competitive environment. Is that not the way all businesses are?

Mr. JOHNSON. My point would be that they would have to absorb the cost because of the competitive environment and they would not be able to pass it on to the consumer unless this happened to involve the whole industry.

Senator HAWKINS. Mr. Poole.

Mr. POOLE. I'd like to point out that in my chart ——

Senator HAWKINS. You like your charts better than mine.

Mr. POOLE. In Chart 1, at the present time the latest observation is that the auto loan rate compared to the 3-year Treasury rate, there's a differential of about 5 percentage points, and that's about the same differential as early in 1972, just a tad higher than early 1975, about the same as late 1976, less than early 1980.

It does not seem to me that the differential is particularly abnormal from past experience. I believe that this is fundamentally a lag phenomenon, that these rates will come down. As I emphasized in my final comment, the differential will close and it's simply terribly important that it close in the right way. That is, by the loan rates coming down rather than the open market rates going up. But I don't think that there is a strong and persuasive case that the differential is abnormally large because of losses in other lines of business.

If you note the numbers that I dug up on the number of these financial institutions, there's simply an enormous number of them. Credit unions, for example, I think are frequently active in the auto loan business and there's about 20,000 credit unions. They've not taken any losses as far as I know on international bank loans. I guess there was one that did have some losses on oil and gas, but it was domestic.

Senator HAWKINS. My time has expired. My colleague has sat here so patiently, I know he's dying to get his hands on you. Senator Proxmire.

Senator PROXMIRE. Thank you, Madam Chairman.

Madam Chairman, first I want to tell you how much I admire your courage. Here it is St. Patrick's Day and you're wearing red. But you made up for it because I notice the last panel consists of Kennedy, O'Connor, and Durkin. So all is not lost.

Gentlemen, as I'm sure you're aware, we're discussing what I think many people would consider the very heart of our economic recovery. This is an interest-rate-caused recession in the view of many people. We have had interest rates that have been so high that they have smothered consumption and we have, as the Chairman and as the chart points out, a situation where the differential seems to be awfully hard to explain.

COMPARING TREASURY BILL RATE, CONSUMER LOAN RATE AND GNP

I have another chart and this chart compares the 3-month Treasury bill rate with the consumer loan rate and the GNP deflator. It shows that whereas the mean differential over the last 10 years was 5.6 percent—that is, the consumer loan rate was consistently about 5.6 percent higher than the 3-month Treasury bills—that it was 9.2 percent higher in 1982, and throughout 1982 it maintained about the same very, very high differential, an extraordinary difference.

My chart shows an even higher differential between the consumer loan rate and the GNP deflator. There, the differential averaged about 5.6 also, but in 1982 it was 13.9 percent. In other words, if you take the difference between the consumer loan rate and inflation, it is higher in relationship to inflation than it's been at any time in the last 10 years by far and spectacularly higher.

So it seems that this is an extraordinary kind of situation, especially in view of the fact that every economist I've listened to—and you're all eminent economists—all seem to agree that the prospects are that we'll have a fairly stable inflation situation over the next year or so with a very high unemployment likely to persist, with unused capacity likely to stay high, and therefore very little pressure on prices. They can see the oil situation and many other situations contributing to the stable prices. Yet you've got this terrific discrepancy.

I haven't heard any really satisfactory explanation from you gentlemen, although I've got great respect for your ability. Want to try again?

Mr. JOHNSON. I would first say that, of course, you're right, you pointed out all the important factors and raised the right questions, Senator, but one problem may be, as we mentioned before, you're talking about posted rates versus a market determined rate like Treasury bills. I'll mention Bill Poole's point once more about——

Senator PROXMIRE. Let me just interrupt. You say an administered rate compared to a market determined rate?

Mr. JOHNSON. Yes.

Senator PROXMIRE. That's exactly the point. This is administered. In other words, this is determined by the people who decide what the rate will be rather than having the market forces determine it.

Mr. JOHNSON. That's correct, but I will refer to what Mr. Poole said before, there are some 40,000 financial institutions who all must decide on a particular posted rate for their own institution and if they post a rate above the rest of the 30,000 or 40,000 competitors, then chances are they would rapidly lose market share and their profits would go down.

Senator PROXMIRE. Isn't there a lot of price leadership here, though?

Mr. JOHNSON. Well, there's an argument that can be made, but even if you look at the big banks that come out first with prime rate announcements, you're still talking about maybe 20 or 30 large national or multinational type of financial institutions, and I think even that number is enough to bring about competition and not allow anyone to hold consumers hostage to an artificially high prime rate.

The other factors you mentioned are correct, but I think the oil price decline and all the other good things that are happening in terms of inflationary expectations will cause these rates to adjust downward. We've only recently had an OPEC announcement of lower oil prices and at the same time I'd remind the committee that we've been through business cycles before when inflation came down due to recession only to go back up as the economy recovered and money was printed too rapidly.

Senator PROXMIRE. We're talking about 12-month consumer loans. We're not talking about 30-year mortgages.

Mr. JOHNSON. Right. I understand.

Senator PROXMIRE. In the next 12 months you should have stable prices so there shouldn't be that much inflation premium.

Mr. JOHNSON. For 1-year instruments I agree, however, I think there will be a lagged adjustment. But there are some other reasons which are associated with the risks of these loans that I think will make the spread higher than you have seen in the 1970s—the new bankruptcy laws and other things that I mentioned before.

Senator PROXMIRE. Let me just step into something else here because we have limited time and we have other panels.

We have before us on the floor of the Senate or will have—it's been postponed for a few days perhaps—a jobs bill. That jobs bill is really peanuts compared to what you can do by getting interest rates down. The jobs bill may provide about 300,000 or 400,000 jobs. If you get interest rates down and keep them down, then we're talking about millions of jobs and a really solid recovery.

So what really can you do? I recall that Arthur Burns, Mr. Martin, as Chairman of the Federal Reserve, did jawbone the banks with some success and other Fed Chairmen have done this; other Presidents have done it. The President lit into the banks the other day because of the imbroglio we have on the floor about interest withholding, but there hasn't been any consistent jawboning by the President or by the Federal Reserve Chairman of the banks to do something about this situation which does seem, just on the basis of what we've had this morning seems to be unfair and unjust to the consumers and the economy.

Mr. MARTIN. I would certainly second the Senator, if I may, in his comment that lower interest rates would be such a stimulus coming from the consumer side to the inventories, to new retail establishments, and so forth— an acceleration ripple through the economy. No question about it.

In terms of the jawboning technique, that has its pluses and its minuses. The Senator is quite right. It has been effective. It has been effective in many areas.

Senator PROXMIRE. If you don't do that, what else can you do?

BANKS SELLING THEIR BRANCHES

Mr. MARTIN. But my caveat, sir, would be that in looking at the banking industry, it is going through—God forbid the cliché—substantial change here on both the liability and asset sides. If jawboning is used by any source, I would only caution that we don't want to drive the marginal lender out of consumer credit by indicating that there is some onus, some complication—that you can't recover your costs here—because many bankers are considering getting out of retailing. They're selling their branches off. They are saying, "we are going to be a wholesale bank, We are not going to deal with the retailing side of business." I certainly wouldn't want to have that effect, to reduce competition in this area.

Senator PROXMIRE. Have you really made an analysis that suggests that that's a real problem, that bankers are getting out of consumer loans?

Mr. MARTIN. There have been quite a few instances of bankers indicating, as I said, that they are going to—wholesaling is now getting to be a subject of discussion.

Senator PROXMIRE. It's easy to understand why they would get out of foreign lending in view of what's happened there and out of some other areas, but this seems to be a very profitable area. Here you've got this terrific margin. It's 12-month money so it shouldn't be at risk so much. I realize there are problems with bankruptcy and so forth which are very bad and we ought to correct, but still it seems to me that ——

Mr. MARTIN. But it's a gross margin.

Senator PROXMIRE. It's a gross margin, but it's a margin that is consistent and now it's terrifically inviting I would think.

Mr. MARTIN. I'm certainly supporting what you say. I don't think it is a terrifically attractive kind of lending. You mentioned personal bankruptcies and the congressional consideration of how that has been implemented. It is still a very high cost operation. It is still an operation that requires you to have a lot of branches and brick and mortar, though that kind of banking is slowly giving way to terminal, automated teller machine banking. It is a very complicated issue and I think the answer is competition. I think the answer is getting the savings and loans into making these kind of loans. I think the answer is to get more banks to come in who are not doing a big retailing business. I think the answer is to get more finance companies in.

Senator PROXMIRE. You don't think there's any answer at all in jawboning?

Mr. MARTIN. I think that is a possibility if we don't run people out. I think it is a good news-bad news combination, sir.

Senator PROXMIRE. Mr. Poole.

Mr. POOLE. I wanted to make a couple technical points and then get at this one.

First, I have to josh my colleague here from Treasury. When we make comparisons using the Treasury bill rate, the 3-month bill rate, we should understand that the Treasury does not follow the conventions that are required in truth-in-lending statements about the determination and statement of interest rates. The bill rate is quoted on a banker's discount basis and to adjust it to the same basis you use on consumer rates you have to add about 75 basis points at current rates of interest.

Senator PROXMIRE. The differential is 900 basis points, though.

Mr. POOLE. I understand the differential is larger, but I'm just saying there are some technical issues here which we need to pay attention to.

Second, there is the differential between a 90-day money and one-year money. If you look at the differential between the Treasury bill rate on 1-year bills, and on 90-day bills, you'll find that it probably averages about a half a percentage point. So you're closing some of the gap that way, by no means all of it, but I'm saying some of it.

Let me talk about the return on a $1,000 loan. Many of these personal loans are small. If you have a return of, say 18 percent on a 1-year loan, you're talking about $180 to cover the cost of being in the business on a loan. If you took a $10,000 auto loan——

Senator PROXMIRE. Let me just interrupt, Mr. Poole. That explains the reason why we've got a differential. There's been a differential consistently over the years, around 5 percent. It doesn't explain why there's a 9 percent differential now. None of these explanations you have given do, but go ahead.

Mr. POOLE. The explanation that I have emphasized in my own statement is the lag which has to do with the fact that market rates of interest have come down rapidly in the last 6 to 8 months and I believe that that's the most important factor.

Senator PROXMIRE. You can't have a lag with adequate competition, can you?

Mr. POOLE. Yes.

Senator PROXMIRE. How?

Mr. POOLE. Because the officers who administer the loan portfolio are, as I've pointed out in my statement, making hundreds and even thousands, if it's a big institution, of loans every month. They have a complicated problem of administering the criteria of deciding who is a good risk and who is not, and they cannot be changing these criteria every day or every other day, which is the way the market rates change. So those changes occur over time as the changes in market rates turn out to be long lasting and justify changes in the consumer loan rates. You see it in the reverse direction. You see it in both directions. You see that the rates lag on the way up and they lag on the way down.

Mr. MARTIN. May I try part of this?

Senator PROXMIRE. My time is up but go ahead.

Mr. MARTIN. All right. I would suggest that the volume of consumer credit is going up and will continue to go up. I would suggest there is going to be some relief in rates. I hope it is substantial but I don't know. I think rate relief is going to come from the use of money market deposit account funds which have now topped $300 billion in the short time since December 14—an unparalleled development in our financial history—and those funds are the ones to be used for consumer credit. Right now, they are paying 8 percent, not counting administrative cost and the brick and mortar writeoff and all those other factors. It has come down from 21 in Atlanta, and 11 here, and so forth. I think that rate is what the banker is going to look at in pricing his consumer paper and then he's going to add onto that an allowance for bad debts, etc., and maybe we'll get something around 11 percent. At 11 percent, I think the consumer will turn on. They have turned on at a touch under 12 percent on automobiles and I think at 11 percent you can push durable goods and so forth. That is the optimistic, the "rosy," scenario that has been chased around these halls.

Senator PROXMIRE. Thank you. My time is up. Thanks, Madam Chairman.

Senator HAWKINS. Thank you.

FAILURE OF REDUCTION IN CREDIT CARD RATES

I'm disturbed also about the failure of the credit card rates to come down. You're talking so much about competition. Several States have removed the rate they can charge. Is there any evidence that credit card interest comes down?

Mr. JOHNSON. That has been a very rigid rate. However, the spread between the credit card rate and even the CD rate shown on your chart or a Treasury bill is less now than it was earlier by about a percentage point. The spread, except for a brief period, is lower now than probably the average, if you look at that chart. It is a very rigid rate and it's associated with high default risks, however, I can't give you a complete explanation.

Senator HAWKINS. Do you have any figures on their annual fee charges. The credit card issuers have learned this new trick of charging annual fees. They have other devices such as increasing merchant discounts. Do the Federal Reserve credit card rate statistics reflect these practices?

Mr. MARTIN. Yes, they do, Madam Chairman. They also reflect the fact that small banks have never made any money on the credit card side and that many——

Senator HAWKINS. What is a small bank?

Mr. MARTIN. $50 million and under in assets, the so-called community bank. I think the community bank has a real future in this country, but this is one area where they have not made any money.

Senator HAWKINS. But aren't they all branch banks now?

Mr. MARTIN. No.

Senator HAWKINS. Do you know what percentage of the community banks are branch banks of a big bank?

Mr. MARTIN. Yes. I am really talking about independent banks, banks that are not branches but are corporate entities unto their own, and I'm talking about the thousands of them that are $50 mil-

lion and under. If you go to $100 million and under, you get a mixed bag, but there have been a lot of years when banks have lost money on this activity.

We would like to see credit card rates come down, from the point of view of the recovery of the economy. But as bank supervisors we're a little troubled. Here is a profit center in which many banks have been losing money. Do you want to push them to bring those rates down and lose some more? We are a little caught on this one.

Senator HAWKINS. Well, would the imposition of selective credit controls, as provided for in the Credit Control Act, help bring down consumer interest rates?

Mr. MARTIN. Yes, it certainly would. The imposition of consumer credit controls, as happened in 1980, would not only bring interest rates down but also would bring down the gross national product. I think the cost of bringing the gross national product down in a weak recovery period would be several times the advantage of bringing down consumer interest rates through selective credit controls.

Senator HAWKINS. You mentioned that mortgage rates are more closely tied to market rates thanks to increased use of mortgage backed securities and the secondary market. Would the development of a secondary market for consumer loan portfolios make consumer rates more responsive to market rates?

Mr. MARTIN. It certainly would, no question about it.

DEVELOPMENT OF SECONDARY MARKET FOR CONSUMER LOANS

Senator HAWKINS. Do you have any ideas, or anybody on the panel, on how the secondary market for consumer loans could be developed?

Mr. MARTIN. I would go back to the history of developing a secondary market for conventional mortgages, which I had something to do with. One of the first things we did in that process was to get the lenders together and get them to standardize their documentation so that a loan is a loan is a loan. It isn't a funny looking piece of paper in this State and another funny looking piece of paper in that State. If the industry could begin to move toward a similar instrument, similar language, similar penalties, that would be an initial step. But you also have the problem of how this kind of pooling of assets would be insured. In the mortgage area, we had the prototype of FHA insurance to go by, and a private mortgage insurance industry which came in following that. I would think the very first step, in that regard, would be an examination of the experience of both FHA/VA and private firms in insuring second mortgages. Realize that's a long answer, but you got me into something.

Senator HAWKINS. What about operating costs? Shouldn't they be coming down? You mentioned computer technology and automated tellers—they have a teller on every corner in my city. I want to tell you he's there 24 hours a day, no people around, brightly lit up, and happily gives you money any time you insert your card. This is a phenomenon that may be nationwide, but in Florida they have replaced every service station that was on every corner. We now have a bank.

BANKING IS A RISKY BUSINESS

Now indeed, if banking is such a risky business, could you explain to me why they are popping up everywhere and at the same time you have to take into account that the brick and mortar that you talked about earlier in this high interest and high cost environment is probably costly also. Rapid growth in my State is expensive, but I would like to have your thoughts on whether operating costs should be coming down as we have more automated tellers on every corner waiting to dispense money?

Mr. MARTIN. I would certainly support the hypothesis that operating costs, with regard to transactions, will come down.

One difficulty on the lending side is that the costs are so much in so-called underwriting—that is the risk analysis of making consumer loans. These costs include such things as tapping into the local credit bureaus to get the credit rating on that family. And the collection expense—functions that are more difficult to automate. Now that is not to say that it would be impossible to automate these functions. You might get into a situation in which you had a credit scoring system that was automated, so that as part of the borrower applicant process the applicant could go over and use a keyboard to help the lending officer obtain some information. But you have to be awfully careful in the credit scoring area, not to be unfair to people, not to deny on the basis of some kind of statistics.

I guess what I'm trying to say is that though it is hard to automate the lending side, I'm not doing very well.

Senator HAWKINS. It seems very simple that when they send a note out that any time you present this card at one of our computer stations you can get a $2,000 loan or whatever it is. It will advance you several thousand dollars if you're in a bind and use it any time. That comes every month in your statement. And yet you're telling me that's the most costly thing about it.

Mr. MARTIN. I admitted to the chairperson that I wasn't expressing it very well. What I was talking about is, for instance, the credit prologue to using the ATM. A person comes in and says, "I want to use the ATM to get credit." The institution says, "Okay, we're going to check you out and see if you have those characteristics and history that we will let you use that machine to get the $3,000." That's where the expense is, not in the actual access to the service.

Mr. JOHNSON. Certainly, if you were able to incur processing costs only once and then standardize the process from then on, it would help. Mr. Martin is exactly right that those costs are high initially, but I think moves to standardize the information process would help.

Senator HAWKINS. I had one final question for Mr. Martin. Do we have a true measure of the banks' cost of funds?

Mr. MARTIN. The Federal Reserve works at measuring the banks' cost of funds, through such studies as the Functional Cost Analysis survey. As you know, we have annually put together these statistics. But I think that the standard errors around any number you get there are pretty wide.

Senator HAWKINS. Thank you, gentlemen, very much. We have two more panels to come before us and I appreciate your participating in this adventure.

Mr. Henry Schechter and Mr. Glenn Nishimura, would you come to the table?

Welcome, gentlemen, to our panel. Mr. Schechter, would you give us your summary first and then Mr. Nishimura.

STATEMENT OF HENRY B. SCHECHTER, DIRECTOR, OFFICE OF HOUSING AND MONETARY POLICY, AFL-CIO

Mr. SCHECHTER. Thank you, Miss Chairlady. I appreciate the opportunity to appear before you on behalf of the AFL-CIO at this hearing on consumer interest rates. The hearing is very timely, coming on the heels of reports of three consecutive monthly declines, through February, in total retail sales. It is noteworthy also that sales in the durable consumer goods component, which depends heavily on use of consumer credit, declined more than twice as rapidly as total consumer sales in February. A sustained economic recovery cannot be achieved as long as retail sales continue to decline.

The AFL-CIO Executive Council expressed its concern about high interest rates in a statement adopted February 21, 1983, which is appended to this testimony. As indicated in that statement, with inflation at about a 4-percent annual rate, consumers are paying 12 to 22 percent for most loans; and home mortgage rates are 12 to 14 percent. Real interest rates being charged on consumer loans are two to three times higher than they should be by historic standards.

I will not go through the chain of evidence of the differential in rates. Your charts display this very well. Every witness who was on the previous panel agreed on that. It is more a question of what causes that and what can we do about it.

There is an indication in this data that financial institutions have held consumer interest rates artificially high in 1982 and 1983 in order to generate earnings to cover anticipated losses on foreign and domestic loan portfolios. This is indicated by the analysis of changes in certain asset brochures of 16 leading banks. I have that on table 2 in the body of my statement.

At the end of 1982, all but two—and these are all large banks—had a higher percentage of outstanding loans in reserves for losses than a year earlier. Also, all but one showed significant increases in the percentages of outstanding loans classified as nonperforming loans and in net chargeoffs as a percentage of loans.

There is an indication in other data that large banks which have been involved in adverse loan experiences both domestically and abroad have had relatively low declining returns on their total assets. Under such circumstances, there is a natural inclination not to reduce high consumer interest rates. Available fragmentary data suggest that banks with less problem loans and charge-offs currently may have lower consumer rates.

HIGH BANK FINANCING AUTO LOANS

Bank financing of automobile loans is at an unnecessarily high rate in many instances, at 15, 16, or 17 percent. At the same time, the finance company subsidiaries of the major auto companies were offering financing at 11.9 percent, and making money on the operation.

Banks insist that they have to charge higher rates now because they have to pay depositors more as a result of the "money market accounts" introduced in mid-December. Incidentally, I do not believe the introduction of those money market accounts will be the reason that they will be able to lower consumer interest rates, as Vice-Chairman Martin indicated, because that money is really practically 1-day money, most of it. I think the influx of the $300 billion within a 3-month period in money market accounts is a good example of what has happened with the household investor. They no longer leave their funds in accounts for a long time but are more likely to deploy it to where it will bring the highest yield.

Therefore, Senator Hawkins, I might come back a little later to the question of the use of selective credit controls because I think the institutions no longer have the control of the flows of funds the way they may think they have. That was shown by this movement of $300 billion in a very short time and it will happen again, especially when we hit periods when interest rates are rising.

But the banks do insist that because of the money market accounts they have higher rates; they've been competing by paying high rates to get the money and that is why they have been paying more. Now this raises a fundamental question which certainly bears consideration by the Banking Committees of the Congress. If consumers are forced to pay more because banks may compete for household depositor funds with unlimited high interest rate payments, is it a wise national policy to permit such unlimited competition?

As of early this year, the interest rates charged on credit card borrowing had not come down from the peaks reached during the last couple of years when States raised the limits on such charges and lenders raised their charges on the credit card. Now the banks also—as the people speaking here before this morning—talk about the great expense of operating the credit card business, the fact that there's a great deal of fraud and much losses. Yet it's hard to understand why they would seek to expand that business so much if there are such great difficulties.

The Bank of America last year sent out 10 million cards trying to induce people to accept their credit cards. The Citicorp, the other of the two largest banks, probably wasn't far behind. They were sending out applications all over the country. And I would like to dwell for a moment on the fact that these two banks, Bank of America that I mentioned—and I would take Continental Illinois which has very large losses through the Penn Square Bank whose loans they took—they have been charging and they still are at the highest level of consumer loan rates and of auto rates respectively. Continental had great losses and both have a high percentage of nonperforming or problem loans. That is shown in some of the statistics in my statement. In other words, it is not that competitive a

business that these large banks with some of the large nonperforming foreign loans will not try to allocate some of the expense to other parts of their business. Also, I don't think it is that competitive with respect to consumer loans because the consumer does not shop around the country the way a large business can to get a loan. In fact, the large business is courted by the banks all over the country but the consumer must generally get his credit in his own town.

Now in New York, for example, Citicorp and Chase Manhattan have hundreds of branches. They have the market advantage in being able to get the business and they happen to be charging higher rates than others in their same market areas for unsecured consumer loans and for automobile loans.

Now for a more definitive answer as to the extent to which other loan losses result in higher consumer interest rates, it is necessary to have detailed information on domestic and foreign loan operations. I would urge that the Banking Committee should obtain such detailed information.

And this is particularly significant I think in view of the periodic calls upon the United States Government to contribute to the International Monetary Fund. In 1977, the IMF established the special $10 billion Witteven Fund to which the United States contributed. Late last year there was an expansion of the General Access to Borrowing Fund of the IMF, and the upcoming increase in IMF capitalization will involve a more than $8 billion U.S. contribution.

Now this still happens to be the only—not the only, but one of the very few types of what I call back-door financing that does not appear in the budget. Nevertheless, it is funds which the U.S. Treasury must contribute and at a time of great deficit it increases the Treasury borrowing and the deficit and therefore has an upward influence upon interest rates.

All of these funds contributions by the United States emphasize the need for the appropriate congressional committees to obtain detailed reports on foreign lending operations of U.S. banks through the established regulatory agencies, and to arrange for special reserves which could absorb part of the losses. If that were done, there would be less need in the future to compensate for losses by keeping consumer interest rates at high levels.

Thank you.

[The complete statement follows:]

Statement of Henry B. Schechter, Director,
Office of Housing and Monetary Policy
American Federation of Labor and Congress of Industrial Organizations
Consumer Interest Rates
Before the Subcommittee on Consumer Affairs,
U.S. Senate Committee on Banking, Housing, and Urban Affairs

March 17, 1983

SUMMARY

I appreciate the opportunity to appear before you on behalf of the AFL-CIO at this hearing on consumer interest rates. The hearing is very timely, coming on the heels of reports of three consecutive monthly declines, through February, in total retail sales. It is noteworthy also that sales in the durable consumer goods component, which depends heavily on use of consumer credit, declined more than twice as rapidly as total consumer sales in February. A sustained economic recovery cannot be achieved as long as retail sales continue to decline.

The AFL-CIO Executive Council expressed its concern about high interest rates in a statement adopted February 21, 1983, which is appended to this testimony. As indicated in that statement, with inflation at about a 4 percent annual rate, consumers are paying 12 to 22 percent for most loans; and home mortgage rates are 12 to 14 percent. Real interest rates being charged on consumer loans are two to three times higher than they should be by historic standards.

There is a chain of evidence indicating that interest rates being charged on consumer loans have been kept at an abnormally high level relative to a declining cost of money to lenders, while interest rates on other types of loans were being reduced.

Over the year ending with February 1982, rates representing the cost of funds to banks -- the federal funds rate and the rate on six-month CDs -- declined by about 1 percentage point, and the prime business loan rate was reduced about 3½ percentage points. However, rates charged by large banks on unsecured personal loans rose by between 1 and 5 percentage points, and the average rate on personal loans by finance companies increased by 1.5 percentage points.

Over the year ending February 1983, the rates on short-term funds borrowed by banks decreased 6 1/3 percentage points, and the prime loan rate was reduced 5.5 percentage points; but the reduction in rates charged by large banks on consumer loans was between zero and 4 percentage points. The interest rate spread widened adversely for consumers, who have less bargaining power than big business borrowers.

There is further evidence to suggest that some financial institutions have held consumer interest rates artificially high in 1982 and early 1983 in order to generate earnings to cover anticipated losses on foreign and domestic loan portfolios. That is indicated by the analysis of changes in certain asset ratios of 16 leading banks. At the end of 1982, all but two had a higher percentage of outstanding loans in reserves for losses than a year earlier. Also, all but one showed significant increases in the percentages of outstanding loans classified as non-performing loans and in net charge-offs as a percentage of loans.

There is an indication in other data that large banks which have been involved in adverse loan experiences both domestically and abroad have had relatively low declining returns on their total assets. Under such circumstances, there is a natural inclination not to reduce high consumer interest rates. Available fragmentary data suggest that banks with less problem loans and charge-offs currently may have lower consumer rates.

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Bank financing of automobile loans is at an unnecessarily high rate in many instances, at 15, 16, or 17 percent. At the same time, the finance company subsidiaries of the major auto companies were offering financing at 11.9 percent, and making money on the operation.

Banks insist that they have to charge higher rates now because they have to pay depositors more as a result of the "money market accounts" introduced in mid-December. This raises a more fundamental question which certainly bears consideration by the Banking Committees of the Congress. If consumers are forced to pay more because banks may compete for household depositor funds with unlimited high interest rate payments, is it a wise national policy to permit such unlimited competition?

As of early this year, the interest rates charged on credit card borrowing had not come down from the peaks reached during the last couple of years when states raised the limits on such charges and lenders raised their charges. In response to complaints from consumers and critical newspaper stories, the lenders claimed that they had to make up for prior year losses on the credit card business, the bookkeeping expenses involved were very high, and there was a great deal of fraud that had to be covered through earnings. Given all of those difficulties, it is hard to understand why the lenders strive so hard to improve their volume of such business.

There may also be some question as to how much of the overhead involved in conducting other types of loan business is being allocated to the credit card business.

For a more definitive answer as to the extent to which other loan losses result in higher consumer interest rates, it is necessary to have detailed information on domestic and foreign loan operations. I would urge that the Banking Committee should obtain such detailed information.

There are periodic calls upon the United States government to contribute to the International Monetary Fund. In 1977, the IMF established the special $10 billion Witteven Fund to which the United States contributed. Late last year there was an expansion of the General Access to Borrowing Fund of the IMF, and the upcoming increase in IMF capitalization will involve a more than $8 billion U.S. contribution. All of these funds contributions by the United States emphasize the need for the appropriate Congressional committees to obtain detailed reports on foreign lending operations of U.S. banks through the established regulatory agencies, and to arrange for special reserves which could absorb part of the losses. If that were done, there would be less need in the future to compensate for losses by keeping consumer interest rates at high levels.

* * * * *

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The AFL-CIO Executive Council expressed its concern about high interest rates in a statement adopted February 21, 1983, which is appended to this testimony. As indicated in that statement, with inflation at about a 4 percent annual rate, consumers are paying 12 to 22 percent for most loans; and home

mortgage rates are 12 to 14 percent. Even though they have receded from the highest levels of the last three years, real interest rates are two to three times higher than they should be by historic standards.

There is a chain of evidence indicating that interest rates being charged on consumer loans have been kept at an abnormally high level relative to a declining cost of money to lenders, while interest rates on other types of loans were being reduced. The relevant experience, relating primarily to banks, is shown in the table on the next page.

It shows selected interest rates paid for funds borrowed by financial institutions and also the rates charged on prime business loans, unsecured personal consumer loans, home mortgages, and finance company personal loans. The rates are shown for the middle month of each quarter starting with February 1981 through February 1983. The two bottom lines in the table show the percentage points change for each type of interest rate from February 1981 to February 1982 and from February 1982 to February 1983.

As can be seen in the year ending with February 1982, the two rates representing cost of funds to banks -- namely, the federal funds rate and the rate on six-month certificates of deposit -- showed a modest decline of 1.15 and 0.88 percentage points, respectively. During that year also, there was a substantial reduction in the prime business loan rate of 3.50 percentage points.

In contrast, the rates on consumer loans by the three leading banks shown in the table increased between 1.00 and 4.76 percentage points. The consumer loan rates charged by finance companies also increased by about 1.5 percentage points, and the average home mortgage rate increased by more than 4 percentage points.

SELECTED INTEREST RATES PAID AND CHARGED BY FINANCIAL INSTUTITIONS

				CONSUMER INTEREST RATES				
				Unsecured Personal Loans#				
	Federal Funds Rate	6-Month CD Rate##	Prime Rate	Chase Manhattan	Illinois Continental	Bank of America	Home Mortgages*	Finance Company Personal Loans**
1981								
Feb.	15.93	16.00	20.00	17.00	16.24	21.00	13.27	21.42
May	18.52	17.66	18.00	17.00	16.24	21.00	15.47	20.75
Aug.	17.82	17.98	20.50	19.00	16.24	22.00	16.75	21.60
Nov.	13.31	12.65	18.00	19.50	16.24	22.00	17.71	22.94
1982								
Feb.	14.78	15.12	16.50	19.50	21.00	22.00	17.33	22.90
May	14.45	13.77	16.50	19.50	21.00	22.00	17.52	22.98
Aug.	10.12	11.53	15.50	19.50	21.00	22.00	17.28	23.20
Nov. 14	9.20	9.13	11.50	19.00	21.00	25.00	15.77	23.34
1983								
Feb. 15	8.51	8.77	11.00	17.25	17.00	22.00	13.92	discontinued
Percentage Points Change								
Feb. 1981 - Feb. 1982	-1.15	-0.88	-3.50	+2.50	+4.76	+1.00	+4.05	+1.48
Feb. 1982- Feb. 1983	-6.37	-6.35	-5.50	-2.25	-4.00	0.00	-1.75	
Nov. 1981 - Nov. 1982								+ .40

minimum rate, 3-three maturity

secondary market

* Federal Home Loan Bank Board, National Average

** Average Rate --Federal Reserve Board

In the year ending February 1983, the rates being paid by financial institutions for funds decreased by more than 6 1/3 percentage points. The prime loan rate was reduced by 5.5 percentage points, but the consumer loan rates charged by the largest bank in the United States showed no change; and the two other large banks whose rates are shown were reduced by 2.25 and 4.0 percentage points. Home mortgage interest rates were reduced by only 1.75 percentage points, and in the past month have come down about another .50 of a percentage point. There can be little doubt that consumers, with less bargaining power than big business, did not benefit equitably from the reduction of money costs to the lenders.

It might be argued that mortgage rates cannot be reduced to the same extent as other loans because they are longer term loans, and an increasing amount of funds held by depository institutions are short-term money market accounts. However, this would not hold for shorter term consumer loans. Furthermore, if real home loan interest rates are to remain so high because of the changed character of depository funds, there is a need for new monetary policies and special institutions so that adequate and affordable home financing can be available in the future.

There is further evidence to suggest that some financial institutions have held consumer interest rates artificially high in order to generate earnings to cover anticipated losses on foreign and domestic loan portfolios. That is indicated by the analysis of changes in certain asset ratios of 16 leading banks, shown on the table on the next page. At the end of 1982, all but two of the 16 had a higher percentage of outstanding loans in reserves for losses than a year earlier. All but one showed significant increases in the percentage of outstanding loans classified as non-performing loans between end of 1981 and end of 1982, and all but one had a significant increase in the net charge-offs as a percentage of loans.

CHANGES IN ASSET QUALITY OF LEADING BANKS

BANK	AS A PERCENT OF YEAR-END LOANS								
	Loan Loss Reserves			Non-performing Loans			Net Charge-Offs		
	1980	1981	1982	1980	1981	1982	1980	1981	1982
Bankers Trust, N. Y.	1.03	1.01	1.09	1.8	2.1	2.1	.305	.209	.41
Chase Manhattan	0.98	1.04	1.01	1.4	1.8	2.5	.296	.247	..41
Chemical, N. Y.	0.88	0.93	1.04	1.4	1.9	2.4	.178	.107	..24
Citicorp	0.69	0.72	0.79	1.5	1.8	2.0	.334	.320	..43
Manufacturers Hanover	0.90	1.03	1.09	1.3	1.6	1.8	.195	.207	..24
J. P. Morgan	0.90	0.93	0.97	0.4	1.3	1.6	.074	(.045)	.22
Bank America	0.84	0.80	0.90	NA	1.7	3.2	.315	.338	.58
Continental Illinois	0.89	0.87	1.13	1.7	2.0	5.6	.228	.221	1.17
First Interstate	1.24	1.19	1.20	1.1	1.9	4.4	.498	.405	.72
First Chicago	0.87	0.89	0.99	4.1	2.5	3.5	.591	.294	.47
First National Boston	1.17	1.24	1.16	1.8	2.6	2.7	.341	.366	.38
Mellon National	1.39	1.29	1.33	1.2	1.8	3.3	.087	.179	.33
First Pennsylvania	1.49	1.61	1.75	6.3	6.4	7.3	2.089	1.202	.87
Interfirst	0.91	0.96	1.20	0.5	1.1	3.2	.286	.229	.45
North Carolina National Bank	1.04	1.05	1.16	0.1	0.2	2.1	.368	.365	.45
Northwest Bancorp.	0.98	0.99	1.17	0.5	1.0	2.7	.301	.284	.67

NA -- not available

Source: Standard & Poor's Banking and Other Financial Services, Current Analysis, March 3, 1983

Five of the aforementioned 16 banks are also included in the table reproduced below from the New York Times of February 20, 1983. In the latter table, there is an indication that banks which have been involved in adverse loan experiences both domestically and abroad have had relatively low declining returns on their total assets. Under such circumstances, there is a natural inclination not to reduce high consumer interest rates. For the year 1982, for example, among the six banks shown in the righthand panel of the table, Illinois Continental had the highest percentage of problem loans related to total loans outstanding (5.6 percent). That resulted in part from a large involvement by Continental in loans that had been originated by the Penn Square Oklahoma Bank that failed during 1982. Continental also had the lowest percentage return on assets, 0.18 percent.

Spotlight on the Banks

The Rates Consumers Pay*

	Unsecured Personal Loans	New Car Loans, 3-year	Conventional Mortgage
Bank of America San Francisco	22%	16%	13.00%
Security Pacific Los Angeles	22	16	13.25
Chemical New York	18	16	13.50
Citibank New York	17	16	13.75
Northwest Minneapolis	13	16	13.50
Continental Chicago	17	16	13.25

* Rates as of Feb. 15.

How the Banks are Doing

Shaded area represents return on assets, in percent; unshaded area represents percent of problem loans to total loans outstanding.

	1978	1979	1980	1981	1982
Bank of America	0.63	0.64	0.62	0.39	0.42
	0.69	0.53	0.92	2.22	4.50
Security Pacific	0.68	0.70	0.69	0.66	0.67
	0.81	1.14	1.12	1.45	2.56
Chemical	0.38	0.40	0.46	0.51	0.60
	3.1	1.9	1.4	1.9	2.4
Citibank	0.61	0.58	0.47	0.48	0.61
	2.6	1.8	1.1	1.3	1.9
Northwest	0.93	0.96	0.90	0.89	0.79
	0.4	0.4	0.4	0.8	1.6
Continental	0.62	0.58	0.56	0.39	0.18
	2.1	1.8	1.6	1.9	5.6

SOURCE: New York Times, February 20, 1983

The next highest problem loan ratio and second lowest return on assets was by the Bank of America, which had been very active in foreign loans to some of the large debtor nations that had to defer payment of principal. This would help to explain why the two banks that have been mentioned did not reduce their consumer loan rates during 1982.

On the other hand, the Northwest Bank has the lowest problem loan ratio, the highest return on assets, and as of February 15 had significantly lower interest rates for unsecured personal loans and for new car loans than the other five banks.

The same table indicates that bank financing of automobile loans is at an unnecessarily high rate in many instances. For three-year, new car loans, one of the banks was charging 13 percent; the other five were charging either 15, 16, or 17 percent. At the same time, the finance company subsidiaries of the major auto companies were offering financing at 11.9 percent, and they are still doing so. Were these auto companies subsidizing the car sale? Apparently not. A recent report by Marian Keller, a Paine-Webber Analyst, said, "GMAC posted record earnings as a result of a decline in borrowing costs relative to lending rates."

The article in the Times in which the table appeared reports that banks insist that they have to charge higher rates now because they have to pay depositors more as a result of the "money market accounts" introduced in mid-December. This raises a more fundamental question which certainly bears consideration by the Banking Committees of the Congress. If consumers are forced to pay more because banks may compete with high interest rate payments, and that means they really must compete without limit for household depositor funds, is it a wise national policy to permit such unlimited competition? The experience of the late twenties followed by the early thirties should have taught an unforgettable lesson.

Such competition led to high-risk loans at high rates, bank losses, and bank failures; high interest rates also become a drag on the economy. While high income individuals with much savings can gain from such policies, the less affluent must suffer as high interest rates are passed on in the price of goods and services. Eventually, the entire economy suffers as business bankruptcies multiply, as they have over the last two years. The feedback in the form of bank losses creates additional impetus for higher rates, and the viscious circle continues.

The level of consumer interest rates is important not only in the context of whether financial institutions are charging rates that are far above their cost of money but also from the viewpoint of the effect of high interest rates upon consumer demand and the economy. It would be worthwhile reconsidering whether unrestricted interest payments on money market and other transaction accounts should be permitted.

As of early this year, the interest rates charged on credit card borrowing had not come down from the peaks reached during the last couple of years as states raised the limits on such charges and lenders raised their charges.

In response to complaints from consumers and critical newspaper stories, the lenders claimed that they had to make up for prior year losses on the credit card business, the bookkeeping expenses involved were very high, and there was a great deal of fraud that had to be covered through earnings. Given all of those difficulties, it is hard to understand why the lenders strive so hard to improve their volume of such business. Last year the Bank of America sent out ten million letters asking individuals all over the country to accept its credit cards. Citicorp (National City Bank of New York) has also solicited credit card business from millions of individuals around the country. National Security Pacific National Bank

is trying to increase its consumer lending this year by 30 percent. The combination of high losses through fraud and the search for millions of clients to use credit cards would suggest that the lenders may not be exercising their characteristic prudence in seeking to expand their volume of credit card business. There may also be some question as to how much of the overhead involved in conducting other types of loan business is being allocated to the credit card business.

For a more definitive answer as to the extent to which other loan losses result in higher consumer interest rates, it is necessary to have detailed information on domestic and foreign loan operations. I would urge that the Banking Committee should obtain such detailed information. Federal financial institution regulatory agencies could assemble and analyze the necessary data. There is no doubt that losses to be encountered in any phase of an institution's operations must be made up from other operations, causing the charges in such other operations to be higher. Not only losses on the loans are involved; the expenses entailed in meetings attended by hundreds of bankers and their lawyers to deal with alteration and rescheduling of loans due from Mexico, Argintina, Brazil, Peru, Venezuela, Poland, and other countries will require institutions to obtain higher earnings from overall operations.

To prevent loan defaults and permit rescheduling of the bank loans, the International Monetary Fund has to make loans to the debtor countries. There are periodic calls upon the United States government to contribute to the International Monetary Fund. In 1977, the IMF established the special $10 billion Witteven Fund to which the United States contributed part of the $5 billion that Congress authorized for international financing institutions that year. Late last year there was an expansion of the General Access to Borrowing Fund of the IMF, and the

upcoming increase in IMF capitalization will involve a more than $8 billion U.S. contribution. All of these funds contributions by the United States emphasize the need for the appropriate Congressional committees to obtain detailed reports on foreign lending operations of U.S. banks through the established regulatory agencies, and to arrange for special reserves which could absorb part of the losses. If that were done, there would be less need in the future to compensate for losses by keeping consumer interest rates at high levels.

Attachment

Statement by the AFL-CIO Executive Council

on

Interest Rates

February 21, 1983
Bal Harbour, Fla.

The nation cannot fully recover from the current deep recession until changes in monetary policy allow interest rates to come down further.

Real interest rates remain two to three times above historic levels, even though they have receded from the highest levels of the last three years. Consumer-loan and home-mortgage rates have declined far less than the prime rate charged by banks. With inflation at about a 4 percent annual rate, consumers are paying 12 to 22 percent for most loans, home mortgages are 12 to 14 percent and prime rates are 11 percent. The best commercial customers get lower rates.

The tight-money policy pursued by the Federal Reserve Board, with the active encouragement of the Reagan Administration, helped push the economy into a prolonged recession. The punishing debt-service burdens inflicted by high interest rates have been a major factor in the commercial and industrial business failures and personal bankruptcies of the past three years. Soaring financing costs have frozen millions out of the consumer markets, particularly the housing and auto markets. New capital investment has been stymied, and needed investments in public facilities have been curtailed. Debt-servicing costs have become a major part of federal expenditures. The results are budget deficits at an all-time record, deep recession and massive unemployment.

Extraordinarily high U.S. interest rates have increased the international exchange value of the dollar relative to the currencies of America's trading partners. Between January 1981 and January 1983, the dollar rose by 29 percent against other currencies. That meant a sharp drop in the price of foreign imports, while the price of U.S. exports rose abroad.

Interest Rates

Banks plagued by bad loans, domestic and international, pass on the costs to their customers through higher interest rates.

To bring down interest rates and get the economy out of the straitjacket of across-the-board tight monetary policies, a supplementary tool is needed. Credit controls were tested and used successfully for that purpose in 1980 under the now-expired Credit Control Act of 1969.

Credit controls are a part of Japan's basic monetary policy and have also been used successfully by other industrialized nations to implement their national economic policies.

The AFL-CIO urges the Congress to re-establish authority for selective credit controls to supplement general monetary policy.

We urge the Federal Reserve Board to bring interest rates down further so that a strong, sustained economic recovery can take place. We reiterate our call for changes in the membership of the Federal Reserve Board and its district bank boards to assure representation of workers, farmers and consumers.

Senator HAWKINS. Thank you, Mr. Schechter.
Mr. NISHIMURA.

STATEMENT OF GLENN NISHIMURA, LEGISLATIVE REPRESENTATIVE, CONSUMER FEDERATION OF AMERICA

Mr. NISHIMURA. Thank you. I am Glenn Nishimura, legislative representative for Consumer Federation of America. CFA is pleased to have the opportunity to appear here today to discuss the problems and causes of high consumer interest rates in the present financial environment. It is a topic that recognizes the importance of consumers having confidence that they are being treated fairly in the credit market.

Consumer Federation of America believes that consumers usually are the least sophisticated and thus the most vulnerable borrowers in the market and therefore they usually assume the burden of any inequities that exist in credit markets. Given the increasing public concern over who and what is causing high consumer rates, we applaud this subcommittee's efforts.

We at CFA and consumers across the country know about high consumer rates. As has been well established this morning, real interest rates are extraordinarily high. They started getting high 2 years ago and they remain at abnormal rates.

While real interest rates have been roosting at this abnormal high level, consumer rates have in fact been escalating. In October of 1982, the Consumer Federation of America issued a study highlighting the fact that, contrary to public perception at that time, consumers were not benefiting from falling prime rates. In that study, Executive Director Steve Brobeck noted that, although the prime rate had fallen precipitously between June of 1981 and September of 1982, consumer rates were rising. Over that period there was a 7-point decline in the prime and a 5-percent drop in inflation, but consumer rates on unsecured loans, for example, increased between 2¾ percent and 5 percent. In recent months, selected unsecured loans and home mortgage rates have shown some decline but they remain high.

The drop we think might have something to do with increased public attention, to which this committee hearing will hopefully add.

Interest rates on credit cards, though, have never been higher and are approaching a national average of 19 percent.

There seems to be a thousand explanations as to why we are experiencing the increasingly high consumer rates. What we hear most are that bankruptcies are rising the cost of funds has increased, and there's a heightened demand for loans. While we think that these factors might have an impact, the magnitude of that impact is arguable. Also, in response to your solicitation Senator, for other explanations that might contribute to high consumer rates, CFA offers the possibility that higher usury ceilings are a direct and dramatic cause of rising interest rates to the consumer. I will get to that later.

Let me address the other issues first. We find little merit in the proposition that increased bankruptcies have a dramatic impact on consumer rates. We base this opionion on two facts. First, histori-

cal patterns demonstrate no escalating real interest rates during previous periods of high bankruptcies. In the mid-1970's for example, bankruptcies increased 33 percent but real interest rates did not skyrocket. Second and more important, losses on consumer loans amount to less than 1 percent of outstanding consumer installment debt, and only a fraction of those bad debts—and the testimony on the House side suggested that only fraction to be one-tenth of 1 percent—is handled through bankruptcies. We think that the impact of bankruptcies on real and consumer rates is probably minimal.

The second issue is cost of funds. Contrary to claims by bankers that they are experiencing a dramatic rise in the cost of funds, there is evidence that the true increase in the cost of funds is really not substantial.

Since the summer of 1982, Federal Reserve policy has driven the discount rate down from 12 percent to today's rate of 8.5 percent. This represents a significant reduction in costs to banks.

MONEY MARKET DEPOSITS

More recently, the emergence of money market deposit accounts and Super-NOW accounts has given financial institutions new instruments with which to attract funds. These accounts at commercial banks have grown from zero in mid-December to over $159 billion in mid-February. That's compared to a total movement in these accounts of around $283 billion. Just at commercial banks, $159 billion was put in, in these 2 months. Now, bankers would have us believe that this money moved into these accounts through low- or no-interest consumer accounts resulting in a sharp jump in their cost of funds, but a closer look unravels this argument.

Over those 2 months, commercial banks experienced a drop of only 3.4 billion from zero-interest-demand deposits and a loss of $19.5 billion from 5¾ percent passbook savings accounts. These two sources together account for less than 15 percent of the total movement into the money market accounts at commercial banks.

Substantially more money has moved into these accounts of small and large time deposits—$50 billion and $38 billion respectively. These time deposits actually may have been earning more interest than they are now getting from the money market accounts, trading away higher interest rates in order to get improved liquidity.

While new money market accounts are paying between 8 and 9 percent to savers, much of that money is coming from accounts that already pay savers at, near, or over that rate. Banks are actually paying substantially more for only a small percentage of that money. In mid-February $154.6 billion remained in zero-interest-demand deposits and $145.5 billion remained in 5¼ percent passbook accounts at commercial banks. In view of these figures, CFA suspects that the cost of funds issue may be highly exaggerated.

The third issue is demand for loans. The increased demand for loans presents a more significant argument in that high competition for loanable funds does tend to drive up interest rates. Two of the major sources of this demand, especially in recent years, is Government borrowing and loans to foreign countries.

Unprecedented Government deficits over the last 2 years have drawn loanable funds from every other economic sector seeking credit. To finance record deficits which have increased from $50 to $60 billion 3 years ago to over $90 billion over the last 2 years, the Government has caused interest rates to rise. A looming Federal deficit of over $200 billion really can only add to the problem.

As to the foreign loan market, the massive increase in international lending by U.S. banks during the past several years has put upward pressure on consumer rates. During the past 5 years, foreign lending by U.S. banks doubled. Although much of this increase represented the recycling of petro dollars, a portion was made possible by the "withdrawal of savings" from the U.S. Just between December 1979 and October 1982, for example, the liabilities of foreign branches of U.S. banks to the United States rose 150 percent from $66.7 billion to $169.3 billion. This transfer of savings from the U.S. to the rest of the world reduced the supply of loan capital available to U.S. consumers, as well as to other domestic borrowers.

Further complicating this matter is a growing belief that foreign borrowers will be unable to meet their obligations to domestic banks. Having already been stung by major collapses such as that involving Penn Square, bankers are now realizing that their speculative, and once highly profitable, foreign loans are crumbling.

On usury ceilings, today's high consumer rates have more to do with rising usury ceilings than any other recent changes. Over the last two years, 44 states have adjusted their ceilings to increase the allowable rates that lenders can charge borrowers and there is evidence that, when state legislators act, consumer rates follow upward almost immediately. A case in point is New Jersey, where in 1981 usury ceilings were lifted to allow finance companies to charge up to 30 percent for loans. The New Jersey average for these types of loans had been at the national average of about 21 percent. But as soon as this new law became effective, these rates shot up 6 to 7 percent and have stayed at that level.

Higher usury ceilings that lead to higher levels of consumer rates are especially burdensome because the market for certain categories of consumer loans is not competitive. For instance, recent reports show that innercity Chicago purchasers of used cars are paying in excess of 50 percent on their loans.

SECOND MORTGAGE STAMPS

But even closer to home, I think this example ought to be reemphasized. In an investigation of second mortgage scams, a local consumer reporter on channel 9, Ellen Kingsley, said there was a great deal of deception going on, that the agent for a mortgage company would prey on unsophisticated homeowners by offering a substantial loan at small monthly payments. In one case she cited, an elderly woman was offered $13,500 deed of trust with a $135 monthly payment. She accepted. She didn't realize that $5,000 of the loan would go directly to the mortgage company for various fees and that she would only receive $8,500. Moreover, she was not told that at the end of the year her balloon payment amounted to

the exact amount she borrowed—$13,500. She thought she was paying on the $13,500; in fact she was just paying the interest.

When you consider the monthly payments and the fees and everything that happened, her effective rate of interest was 80 percent.

Now after Miss Kingsley presented this on TV she received about 21 phone calls saying, "We've also been caught in that. We don't know what to do. What can we do?" Miss Kingsley reported that because of D.C. laws on usury some of those people did not lose their homes.

If Federal preemption had voided D.C. law, we wonder whether all those people would have been so fortunate—this kind of situation occurs even where usury limits do exist. Fortunately, consumers have recourse. I would repeat that borrowers in certain categories experience noncompetitive markets for loans, that exorbitant consumer rates prey on those least able to afford them, and reasonable usury ceilings appropriately protect the relatively unsophisticated borrower from credit gouging.

I think the panel following this one is going to suggest—it's shocking to me, Senator—that one of the responses the Senate should make is to preempt usury ceilings. I consider that comparable to offering a glass of water to a drowning person.

This committee recognizes that consumer rates are high. I don't think the adequate response is to allow lenders to charge higher rates.

Consumer Federation of America has two recommendations that would have direct bearing on this hearing. First, we urge the Senate Banking Committee to once again reject attempts to federally preempt all State usury ceilings. A Federal preemption would add more costs to consumer loans than any other change. With consumer installment credit rising to nearly $350 billion, every 1 percent increase in the average annual percentage rate will result in a $3.5 billion transfer from consumers to lenders. We have no doubt that Federal preemption would result in increases far greater than that 1 percentage point. We ask that the full committee reject this unwise and inflationary proposal.

Second, and more directly related to the question of real interest rates, we urge Congress to extend the Credit Control Act of 1969. In doing so, Congress should provide guidance as to how selective credit controls should function—specifically to discourage nonproductive uses of credit that deplete loanable funds and drive up interest rates. Our economy has experienced such nonproductive commitments of exorbitant sums in the corporate takeover craze of 1981 which according to a National Council on Low Interest Rates study, tied up $30 to $38 billion of loanable funds. Credit controls could also be used to prevent the type of serious overextension to foreign borrowers that we witnessed in 1982.

The governments of nearly all developed capitalist economies intervene in credit markets to encourage desirable and discourage undesirable uses of credit. We believe that the Federal Reserve's recent signal that they would pay attention to the growth of total credit is an important first step. The passage of a "Low Interest Rate Act" to manage that growth in credit should follow and we seek your active support for its affirmation by Congress.

19-096 O—83——6

This investigation of high consumer interest rates is an auspicious beginning for the new leadership of this subcommittee. CFA appreciates the concern embodied in the calling of this hearing and stands ready to assist in any way we can.

[The complete statement follows:]

Statement of

GLENN NISHIMURA, LEGISLATIVE REPRESENTATIVE

On Behalf of

CONSUMER FEDERATION OF AMERICA

Senator Hawkins and Members of the Subcommittee. I am Glenn Nishimura, Legislative Representative for Consumer Federation of America. CFA is pleased to have the opportunity to appear here today to discuss the problems and causes of high consumer interest rates in the present financial environment. It is a topic that recognizes the importance of consumers having confidence that they are being treated fairly in the credit market.

Consumer Federation of America believes that consumers usually assume the burden of any inequities that exist in the credit market because they are the least sophisticated and thus the most vulnerable borrowers. Given the increasing public concern over who and what is causing high consumer rates, we applaud this subcommittee's efforts.

Real interest rates are extraordinarily high. Exactly how abnormal real interest rates are now or how stable those rates have been in the past may have escaped the casual observer.

During the twenty years prior to 1980, real interest rates never exceeded three percent (see appendix). Notably, even during the hard economic times that we experienced in the mid '70's, the prime and inflation rates never strayed very far from each other. However, through 1981 and 1982, the real interest rate shot up, then hovered at 2 to 3 times its historical average. In January of this year the prime stood at 11.6 percent while inflation had dropped to 2.1 percent, maintaining a real rate of 9.5 percent.

While real interest rates were roosting at this abnormal high, consumer interest rates were escalating. In October of 1982, a CFA study highlighted the fact that, contrary to public perception, consumers were not benefiting from falling prime interest rates. In this study, Executive Director Steve Brobeck noted that, although the prime rate had fallen precipitously between June of 1981 and September of 1982, consumer rates were, in fact, on the rise.

Over that period of a 7 point decline in the prime and a 5 percent drop in inflation, consumer rates on unsecured loans rose between 2 3/4 and 5 percent. In recent months, selected unsecured loans and home mortgage rates have shown some decline but they remain high. Interest rates on credit cards have never been higher, now approaching a national average of 19 percent.

Theories abound that attempt to explain away both the irregularities of real interest rates and the increasingly higher consumer rates. Problems most often pointed to are the rise in bankruptcies, costlier loanable funds and heightened demand for loans. While each of these factors may have an impact, the magnitude of that impact is arguable. CFA believes that, in addition, higher usury ceilings are a direct and dramatic cause of rising consumer rates. We have examined each of these hypotheses.

Bankruptcies. Though much has been made about the sharply increased number of bankruptcies and its impact on real interest rates and consumer rates, we find little merit in this argument for two reasons. First, historical patterns demonstrate no escalating real interest rates during previous periods of high bankruptcies. In the mid 1970's, bankruptcies increased by 33% without significant impact on real interest rates. Second, losses on consumer loans amount to less than 1 percent of outstanding consumer installment debt, and only a fraction of those bad debts are handled through bankruptcies. Consequently, the impact of bankruptcies on real and consumer rates is probably minimal.

Costs of Funds. Contrary to claims by bankers that they are experiencing a dramatic rise in the cost of funds, there is evidence that the true increase in the cost of funds is not substantial.

Since the summer of 1982, Federal Reserve policy has driven the discount rate down from 12 percent to today's rate of 8.5 percent. This reduction represents a significant reduction in costs to banks.

More recently, the emergence of Money Market Deposit Accounts (MMDA) and Super NOW accounts has given financial institutions new instruments with which to attract funds. The MMDA's at commercial banks have grown from zero in mid-December to over $159 billion in mid-February. Bankers would have us believe that most of this money has been drawn from low or no interest consumer accounts, resulting in a sharp jump in their cost of funds. A closer look unravels this argument.

Over those two months, commercial banks experienced a drop of only 3.4 billion from zero interest demand deposits and a loss of $19.5 billion in 5½% passbook savings accounts. These two sources together account for less than 15 percent of the total movement into the MMDA's at commercial banks.

Substantially more money was drained from higher paying small and large time deposits at commercial banks - $50 billion and $38 billion respectively. These time deposits actually may have been earning more interest than they are now getting from the MMDA's, trading away higher interest rates in order to get improved liquidity.

While new MMDA accounts are paying between 8-9 percent to savers, much of the money is coming from accounts that already pay savers at, near or over that amount. Banks are actually paying substantially more for only a small percentage of that money. In mid-February, $154.6 billion remained in demand deposits and $145.5 billion remained in 5½ percent passbook accounts at commercial banks, giving them a base of stable, cheap loanable funds. In view of these figures, CFA suspects that the cost of funds issue may be highly exaggerated.

Demand for Loans. The increased demand for loans presents a more significant argument in that high competition for loanable funds does tend to drive up interest rates. Two of the major sources of this demand, especially in recent years, is government borrowing and loans to foreign countries.

Unprecedented government deficits over the last two years have drawn loanable funds from every other economic sector seeking credit. To finance record deficits which have increased from the $50 - 60 billion dollar range 3 years ago to over $90 billion over the last two years, the federal government has caused interest rates to rise. A looming deficit of over $200 billion can only add to the problem.

As to the foreign loan market, the massive increase in international lending by U. S. banks during the past several years has put upward pressure on consumer rates. During the past five years, foreign lending by U. S. banks doubled. Although much of this increase represented the recycling of petro-dollars, a portion was made possible by the "withdrawal of savings" from the U. S. Just between December 1979 and October 1982, for example, the liabilities of foreign branches of U. S. banks to the United States rose 150% from $66.7 billion to $169.3 billion. This transfer of savings from the U. S. to the rest of the world reduced the supply of loan capital available to U. S. consumers (as well as to other domestic borrowers), thus pushing up consumer rates.

Further complicating matters is a growing belief that foreign borrowers will be unable to meet their obligations to domestic banks. Having already been stung by major collapses such as that involving Penn Square, bankers are now realizing that their speculative, and once highly profitable, foreign loans are crumbling.

Usury-ceilings. Today's high consumer rates may have more to do with the rising usury ceilings than with any other recent changes. Over the last two years, 44 states have adjusted their ceilings to increase the allowable rates that lenders can charge borrowers. There is evidence that, when state legislators act, consumer rates follow upward almost immediately. A case in point is New Jersey, where in 1981 usury ceilings were lifted to allow finance companies to charge up to 30% for loans. The New Jersey average for these types of loans had been at the national average of about 21%. As soon as the new law became effective, these rates shot up 6-7% and have stayed at that high level.

Higher usury ceilings that lead to higher levels of consumer rates are especially burdensome because the market for certain categories of consumer loans is not competitive. Recent reports show that inner-city Chicago purchasers of used cars are paying in excess of 50% on their loans. Exorbitant consumer rates prey on those who are least able to afford them and reasonable usury ceilings appropriately protect the relatively unsophisticated borrower from credit gouging.

Consumer Federation of America has two recommendations that would have direct bearing on the economic conditions being discussed today. First, we urge the Senate Banking Committee to once again reject attempts to federally preempt all state usury ceilings. A federal preemption would add more costs to consumer loans than any other change. With consumer installment credit rising to nearly $350 billion, every 1 percent increase in the average Annual Percentage Rate will result in a $3.5 billion transfer from consumers to lenders. We have no doubt that federal preemption would result in increases far greater than that one percentage point. We ask that the full committee reject this unwise and inflationary proposal.

Second, and more directly related to the question of real interest rates, we urge Congress to extend the Credit Control Act of 1969. In doing so, Congress should provide guidance as to how selective credit controls should function - specifically to discourage non-productive uses of credit that deplete loanable funds and drive up interest rates. Our economy has experienced such nonproductive commitments of exorbitant sums in the corporate takeover craze of 1981 which according to a CFA study tied up $30-38 billion dollars of loanable funds. Credit controls could also be used to prevent the type of serious overextension to foreign borrowers that we witnessed in 1982.

The governments of nearly all developed capitalist economies intervene in credit markets to encourage desirable and discourage undesirable uses of credit. We believe that the Federal Reserve's recent signal that they would pay attention to the growth of total credit is an important first step. The passage of a "Low Interest Rate Act" to manage that growth in credit should follow and we seek your active support for its affirmation by Congress.

This investigation of high consumer interest rates is an auspicious beginning for the new leadership of this subcommittee. CFA appreciates the concern embodied in the calling of this hearing and stands ready to assist in any way we can.

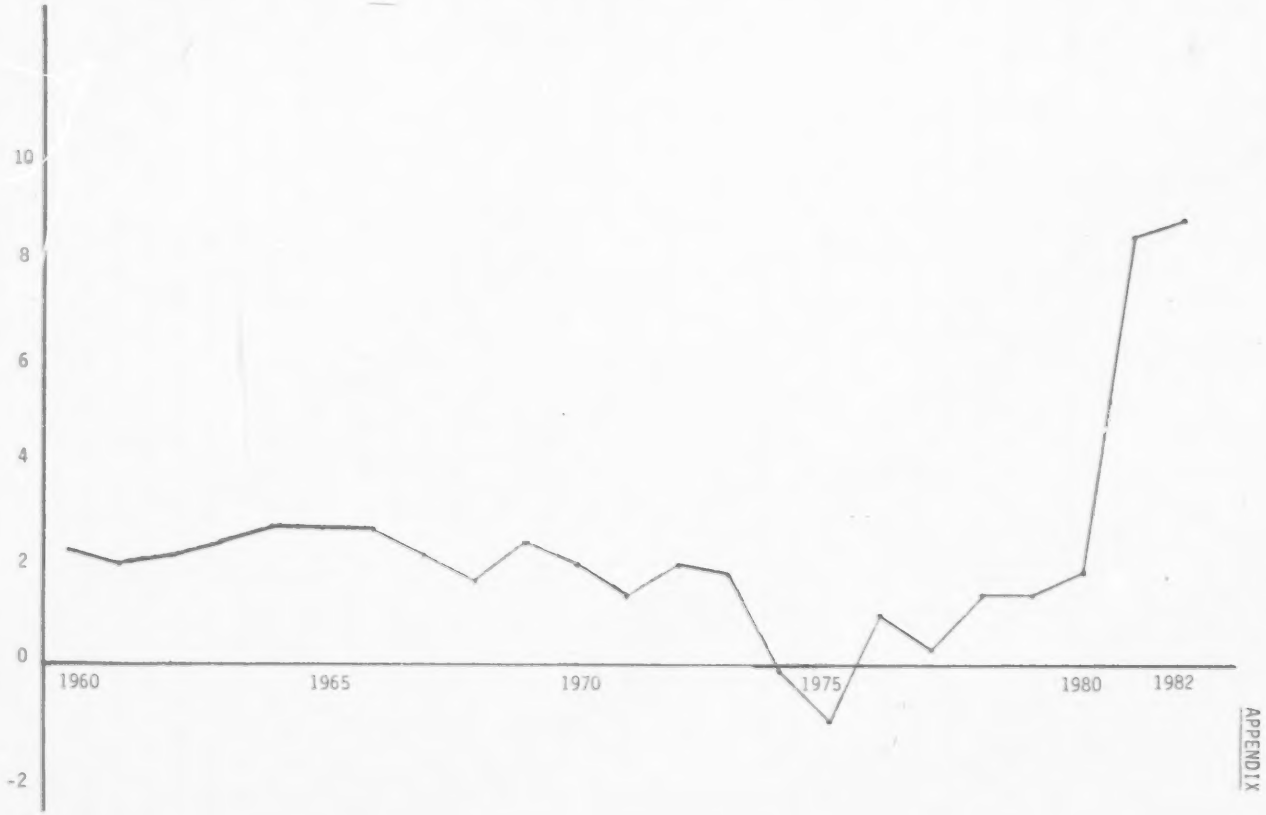
APPENDIX

HISTORIC REAL INTEREST RATES

YEAR	PRIME RATE	INFLATION RATE	REAL INTEREST
1960	3.9	1.6	2.3
1961	3.0	1.0	2.0
1962	3.3	1.1	2.2
1963	3.6	1.2	2.4
1964	4.0	1.3	2.7
1965	4.4	1.7	2.7
1966	5.6	2.9	2.7
1967	5.1	2.9	2.2
1968	5.9	4.2	1.7
1969	7.8	5.4	2.4
1970	7.9	5.9	2.0
1971	5.7	4.3	1.4
1972	5.3	3.3	2.0
1973	8.0	6.2	1.8
1974	10.8	11.0	- .2
1975	7.9	9.1	-1.2
1976	6.8	5.8	1.0
1977	6.8	6.5	.3
1978	9.1	7.7	1.4
1979	12.7	11.3	1.4
1980	15.3	13.5	1.8
1981	18.9	10.4	8.5
1982	14.9	6.1	8.8
1983 Jan.	11.6	2.1	9.5

Source, Federal Reserve Board, Bureau of Labor Statistics

REAL INTEREST RATES - 1960 - 1982



Senator HAWKINS. Thank you, Mr. Nishimura.

Mr. Schechter, could I ask a question about the chart? Do you find any justification for the 6-point spread between what banks are now paying for their money and what they are charging consumers for new auto loans as illustrated by the bar graph?

Mr. SCHECHTER. I don't find the justification and in fact probably the adverse or inequitable treatment to the consumer is even worse than the chart shows, because we had things like the prime being reduced greatly and it isn't only the cost of money to the banks, but other borrowers with more power are reaping the benefits of an easier Federal Reserve policy whereas the consumer is not. As one witness indicated, the prime doesn't any longer mean the lowest rate to the best business borrower. Now there are lower rates than the posted prime. So I think there is no justification for that spread.

Senator HAWKINS. Do you have any evidence that some banks have held their interest rates artificially high to generate earnings to cover bad loans, either domestic or foreign?

RESCHEDULED FOREIGN LOANS

Mr. SCHECHTER. To really examine that, what is needed is more evidence than I can obtain. For example, I don't know, and I doubt whether members of this committee know, the terms of loans that our large banks made on these foreign loans which now are not able to be repaid on time and have to be rescheduled. Are those rates even so excessive that they were high risk to start with?

How are the expenses of managing that allocated? Almost once a week now you read of a meeting of 100 bankers or 120 bankers to consider rescheduling of the loans in Peru or Venezuela or Argentina or Mexico, and they meet either in the New York Hyatt or in Geneva or in London. Now all these expenses—how are they allocated?

It may seem like a very small thing compared to the billions of dollars, but this is just symptomatic of the fact that unless we have a detailed knowledge of what is done to spread out the losses or reductions in anticipated income, we can't answer that definitively.

I have a few scraps of evidence here that some of those banks happen to be charging higher consumer loan rates than others in similar markets than other banks that perhaps weren't involved in such losses. But to really know the answer, we need the type of detail that I speak of and certainly with the U.S. Government being a contributor periodically, via the IMF, to help reschedule or whatever other term you want to use, which relieves some of the banks of their difficulty, I think we have a perfect right for the committees of Congress to obtain such information.

Senator HAWKINS. There's an article in this morning's Post indicating that many of the Virginia retailers are going to take advantage of the new law that removes the State's 18-percent rate ceiling on credit cards and that next month they're going to start charging as much as 21.6 percent.

STATES ADJUST INTEREST RATES

Mr. Nishimura, you said that 44 States have lifted their usury ceiling. First, is there any State that you know that lowered the interest rates when they took off the ceiling?

Mr. NISHIMURA. Senator, my statement was that 44 States adjusted their ceiling. Not all of them lifted it. I would mention that prior to coming up to Washington to become a legislative representative for CFA, I spent 8 years as consumer advocate in Little Rock, Ark. It seems obligatory to talk about Arkansas every time we talk about usury ceilings, and I'm sure that Mr. Kennedy who will follow me will talk about it, also.

But I was heavily involved in the usury issue in Arkansas, if I may get off the track a little bit. I think that the characterization of what has happened in Arkansas has been greatly simplified as being boiled down to consumers voting against their best interests and consumers voting because they're from Arkansas. I think the consumers knew what they were doing when they did that. They kept consumer rates down for a long time and in fact when rates were finally changed in 1982 a lot of the protections that consumers had asked for in two previous elections, 1974 and 1980, were in fact retained. I think that's one of the reasons the changes were accepted in Arkansas.

Just another interesting thing I'd like to point out. In 1981 when voters did reject the attempt to override the constitutional ceiling in Arkansas, our analysis showed that the majority of people that were in the inside part of the State, towns that surrounded my home of Little Rock and actually Mr. Kennedy's home, Pine Bluff, voted against it. And the counties where the majority voted for that proposal—it was an amazing chart—[illegible] lined the edges of the State. One reason for this, we suspect [illegible] that those counties are subject to outside media, for instanc[illegible] media [illegible]ing in from Memphis, Oklahoma, or Shreveport, aski[illegible] [illegible] to come in and get all this money. But the people in the [illegible] part [illegible] the State did not feel they needed all that money t[illegible] borr[illegible] But that is a long answer to your question. No, I don't kn[illegible] anybody who has lowered interest rates, although they tried t[illegible] Washington, as Senator Gorton knows.

Senator HAWKINS. Senator Gorton has joined us as you've noticed and I'd like to give him an opportunity at this time to make a statement and ask questions of this panel.

Senator GORTON. Thank you very much but, unfortunately, it looks as though we have only a very short period of time.

I'd like to follow up on that last set of questions because Mr. Nishimura knows the State I represent has had limitations and those limitations have been changed to a certain extent.

Could you give me a description of the pattern of change which takes place either as a result of a significant limitation on consumer interest rates or of the removal of those limtations?

Let me be more specific. When interest rates for consumers sharply increased as a result of a lifting, is there a sharp decline in the number of people who are borrowing money on consumer loan rates? In addition, what is your response to the critique that where

interest rates are kept artificially low, the cash purchaser in effect pays a subsidy to the credit purchaser?

Mr. NISHIMURA. Senator, my information arises from my experience in Arkansas. There was a study out of Purdue that claimed to show that prices in Arkansas were higher than prices elsewhere. That study was very much discredited at that time and I have seen no study that supports that data. We have seen a study that questions the effect of the low interest ceiling on the availability of funds. That study showed that the consumer in Arkansas under a 10-percent ceiling, especially the low-income consumer, had as much credit burden as consumers in surrounding States like Louisiana and Oklahoma that had interest rates of 31-percent ceilings.

In answer to your question, we can only make inferences from the information that we see. The CFA is interested in plotting the pattern on what happens in situations described by your question, what happens to credit borrowers in environments where the usury ceiling has been lifted. But that is still in the works and we do not have that study ready.

Senator GORTON. One question for Mr. Schechter and then I'll turn it back to you, Madam Chairman.

Perhaps it's a dual question. I noted both in your written testimony and in your response to Mrs. Hawkins that you said that you had some evidence that banks which did not have heavy involvements in foreign loans which they had had to turn over had lower consumer interest rates than those that did.

I would like you to amplify on that a little, but I'd like you to answer a more philosophical question. Is it the implication of your testimony that a bank should not be allowed, because it's losing money in one part of its business, to try to make it up in another? Would you say if a bank was losing money in its consumer loans that it shouldn't charge larger commercial rates in order to make up for that or the other way around?

Mr. SCHECHTER. First, on the data I indicated I had fragmentative data and I indicated we needed a lot more detail. I have on page 9 of the testimony a small chart taken from the New York Times which indicates on the right-hand side the ratios of bad loans, problem loans, compared to total loans outstanding that the banks had, and you will notice the two highest ratios are the Bank of America who is active in international lending and Continental of Illinois which was involved with Penn Square and suffered heavy losses there.

At the same time, when it comes to the consumer loans, particularly the Bank of America, had very high rates for personal loans.

Senator GORTON. Continental was down in the middle though?

Mr. SCHECHTER. Continental was in the middle. On the other hand, Northwest Minneapolis which has the lowest consumer rates, also happened to have the lowest problem loans. I have something which is not in my testimony but this is a report of the New York State Banking Department as of November 1982, and they show the annual percentage rates on various types of consumer loans. It's on nine fairly large banks in New York City, as shown in the following table.

ANNUAL PERCENTAGE RATES
ON VARIOUS TYPES OF CONSUMER LOANS
LARGE COMMERCIAL BANKS
IN NEW YORK CITY
November 1982

	Second Mortgage Loans	Loans Secured by Savings Accts.	Overdraft Checking Loans	Unsecured Personal Loans
Bank of New York	15.50 *% (17.00)*	17.50 %	19.80 %	19.00 % (20.50)
Chase Manhattan Bank, N.A.	14.50	19.00	19.50	19.00
Chemical Bank	16.50 ** (17.50)**	15.50	19.50	18.00 (19.00)
Citibank, N.A.	17.05 (19.05)	18.00	19.50	19.00 (21.00)
European American Bank	-	10.27	18.10	17.50 (20.00)
Irving Trust Co.	-	17.75	18.00	18.75 (19.00)
Manufacturers Hanover Trust Co.	17.67 (18.18)	16.50	19.80	18.00 (19.00)
National Bank of North America	-	16.00	18.00	18.00 (19.00)
Republic National Bank	-	16.00	18.00	18.50 (20.50)

* Plus 3 points.

** Plus 2 points.

Source: New York State Banking Department, "The Price and Availability of Consumer Credit in New York State," December 1982

HIGHEST RATES CHARGED

The highest personal loan rates being charged were by Citibank and Chase Manhattan, the two that do a good deal in international lending. So that is fragmented evidence.

I do not think that a bank should be told that it cannot allocate its expenses. That is their managemental business decision of course, but I think that when the banks engage in activity which then requires U.S. support in billions of dollars, then the Congress of the United States representing the people of the United States in effect has a certain interest in the type of lending that is being done and how the expenses or losses are allocated. It's a matter of direct dollars and cents, if you will, that here the taxpayers of the United States contribute with the approval of the U.S. Congress, and therefore the U.S. Congress I think has a duty to look more closely at what is happening in that business which then raises the cost of consumer interest rates.

Mr. NISHIMURA. Senator, excuse me. Just for purposes of clarifying the record, I just realized that the study that I referred to about price was a study by Dr. Gene Lynch from the University of Arkansas and not a study that came out of Purdue.

Senator GORTON. Thank you very much.

TRUTH-IN-LENDING

Senator HAWKINS. Thank you, Senator. We have a few minutes left before we have to make the vote. There's an article in today's Wall Street Journal that some consumers are confused over the advertising of low interest rates by automobile dealers. You heard me ask the previous panel that there may have been violations of the Truth-in-Lending Act through charging credit and charge customers different prices for the same automobile.

Do either of you men who represent consumers have any comment on that practice?

Mr. SCHECHTER. I didn't get the last part of that.

Senator HAWKINS. Do either of you have a comment on that practice, any information that this is happening. 11.9 percent as advertised interest for a car, but indeed if you pay cash it's not as much.

Mr. SCHECHTER. The 11.9 percent, for example, I quote from Marian Keller, an analyst for Paine-Webber, a Wall Street firm, who did an analysis of the GMAC lending, and she said the GMAC was earning money in its own operation. In other words, there is no reason to believe that there was any subsidy going into that operation because GMAC with that 11.9 percent financing was able to show profits.

Senator HAWKINS. Thank you. I have to vote. This hearing is recessed until two o'clock.

[Whereupon, at 11:55 a.m., the hearing was recessed, to be reconvened at 2:00 p.m., this same day.]

AFTERNOON SESSION

Senator HAWKINS. The hearing is reconvened. I call on panel III—Mr. Kennedy, Mr. O'Connor, and Mr. Durkin.

Welcome, gentlemen. Mr. Durkin.

Mr. Kennedy, does Senator Dole know you are in town?

Mr. KENNEDY. He probably will in a while anyway.

Senator HAWKINS. I won't tell him where you are.

Mr. DURKIN.

STATEMENTS OF WILLIAM H. KENNEDY, PRESIDENT, AMERICAN BANKERS ASSOCIATION, CHAIRMAN, NATIONAL BANK OF COMMERCE, PINE BLUFF, ARK.; LEONARD F. O'CONNOR, MEMBER, EXECUTIVE COMMITTEE, CONSUMER BANKERS ASSOCIATION, VICE PRESIDENT, FIRST NATIONAL BANK OF BOSTON; AND THOMAS DURKIN, DIRECTOR OF RESEARCH, AMERICAN FINANCIAL SERVICES ASSOCIATION, WASHINGTON, D.C.

Mr. DURKIN. Thank you, Madam Chairman.

My name is Thomas Durkin. I am director of research of the American Financial Services Asociation and Adjunct Senior Research Associate in Finance at the Pennsylvania State University. I welcome the opportunity to participate in this hearing and to offer AFSA's views on consumer loan interest rates.

The sharp fluctuations in market interest rates in recent years have increased public attention to the course of financial markets and the behavior of financial institutions.

Senator HAWKINS. Would you excuse me a moment? I just heard from my staff that they gave Mr. Kennedy a commitment. Is that the way it is?

Mr. KENNEDY. I would appreciate it.

Senator HAWKINS. I am sorry, we had to run over through the afternoon.

Mr. KENNEDY. That is perfectly all right, but I do have a 3 o'clock appointment.

Senator HAWKINS. Then you had better talk fast.

Mr. KENNEDY. I will do my best. [Laughter.]

Madam Chairman and members of the subcommittee, I am William H. Kennedy, Jr., chairman of the Board of the National Bank of Commerce, Pine Bluff, Arkansas and president of the American Bankers Association. Our association's nearly 13,000 member banks represent more than 95 percent of commercial bank assets.

We appreciate this opportunity to testify before this subcommittee. We believe there has been some misunderstanding as to the role of full service banks in determining interest rates, and we are pleased to be here to discuss this subject.

Madam Chairman, it takes time for people to adjust when the world around them changes. Unlike computers, people cannot be reprogrammed at will.

All of us are influenced by what we have experienced. The fresher and more dramatic the experience, the greater the influence of our thoughts and actions.

For more than 10 years, the people of this nation were ravaged by inflation. I liken this experience to a train from the sea coast to the mountains. There were peaks and there were valleys along the way, but over the course of time the track rose ever higher and higher.

INFLATIONARY CYCLE

The inflationary cycle produced high and volatile interest rates, unacceptably high unemployment, and significant dislocations in credit flows. People who put their money into fixed rate bonds and deposits found the real value of their investments eroded as inflation soared above the yield earned on their investments.

The public heard Congress after Congress and administration after administration promise to restore economic health, reduce inflation, and balance the budget. Each time the public was disappointed.

This unhappy track record has created public skepticism regarding the ability and the willingness of the Government to follow through with an antiinflation program. Until this skepticism is overcome, the outlook for inflation remains in doubt.

Over the years people gradually adjusted to inflation. Part of that adjustment was that savers demanded a premium for inflation when they deposited funds with a financial institution. Until people develop the confidence and we return to price stability, savers will continue to demand this inflation premium. Until people adjust, this premium will be reflected in interest rates to borrowers.

True, Madam Chairman, in part because of the efforts of this Congress and this administration, both inflation and interest rates have shown some improvement. However, legitimate concerns have been raised about the level of interest rates vis-a-vis the rate of inflation and about the effects of today's interest rates on economic recovery.

We all want lower interest rates and an adequate flow of credit to all sectors of the economy, but I must again stress that the only way to lower interest rates, including consumer interest rates is to convince the public that the Government is firmly and irrevocably committed to maintaining price stability.

Well, where do banks fit into the picture? Banks are financial intermediaries. As intermediaries, they buy their raw material, money, primarily in the form of customer savings and then process and resell this money in the form of loans. The cost of acquiring money from deposits is the primary determinant of the price that it is sold at as loans.

There are, however, other factors that influence this price, which I will mention in a moment.

The important point is that the cost of funds relative to the inflation rate is higher than during most any other period of recent economic history. The United States Treasury discovers this every week. When it acquires funds from the public, it must pay a substantial inflationary premium to market its debt.

Banks, like the Treasury, discover this fact every day in transactions with our customers. Inflationary expectations continue to foster inflationary premiums. The inflationary premium accounts for the great bulk of the difference between measured inflation rates and actual loan rates.

The upshot is that lending rates will decrease when savers no longer demand the inflationary premium for their savings. The treasury bill market is a good proxy for the price which savers demand, and it is out of sync with the immediate past inflation rate, but not in the eyes of those who buy the inflation rate in prospect.

I would like to stress one other principal point. Credit markets are highly competitive. Rates for borrowers and lenders are the results of countless daily transactions among market participants, ranging from small savers to large corporate borrowers. Each weighs the needs for liquidity, safety, and yield, and each chooses among the array of financial instruments available. Borrowers gage their needs for funds and choose among the array of credit instruments available.

There are too many buyers and sellers of financial services for any one bank, savings and loan, credit union, and so forth to either obtain funds at rates significantly below those available elsewhere or to loan funds at rates significantly above those charged elsewhere.

As I said before, in addition to the cost of acquiring funds, there are other factors that influence the rates borrowers are charged—the cost factors associated with holding funds, packaging them, and marketing them in the forms of products to potential borrowers. Among the factors that bankers take into account when pricing loans are credit risks, transaction costs, size of the transaction, the term of the loan and whatever security the borrower pledges as collateral, not to mention the expected decline in purchasing power of the money.

There is also a growing and serious cost brought about by the failure of an increasing number of borrowers to repay their loans. You heard all this this morning, Madam.

In addition, the Federal Reserve System requires banks to hold reserves on deposits for monetary policy purposes. These reserves pay no return. Thus, the potential investment income of these funds is lost and represents yet another cost to the banking business.

Coming from Arkansas, as was Mr. Nishimura, I cannot overlook the costs that arise from State usury laws, particularly when lenders take losses from loan commitments made before market rates rise above the artificially imposed ceilings.

Madam Chairman, our complete statement discusses all of these factors. In conclusion, I would like to emphasize that we operate in a market economy. The market is working perhaps not in the way some people would wish, but it is working.

19-096 O—83——7

The best action the Government could take to increase the market's efficiency to benefit everyone would be to restore price stability to cure the disease of inflation. The worst action the Government could take would be to attack the symptoms of inflation while ignoring the disease. When the Government tries to administer prices, to whatever end, not only is everyone injured in the short run by disruptions imposed on the system, in the long run the effort will fail to achieve its goals.

Thank you very much. I will be pleased to answer any questions.

[The complete statement follows.]

STATEMENT

OF

WILLIAM H. KENNDEDY, JR.

on behalf of

THE AMERICAN BANKERS ASSOCIATION

Madam Chairman and Members of the Subcommittee, I am William H. Kennedy, Jr., Chairman of the Board of the National Bank of Commerce, Pine Bluff, Arkansas, and President of the American Bankers Association. Our Association's membership includes more than 90% of the nation's full service banks. While our members range in size from the smallest to the largest banks, approximately 90% of them have assets less than $100 million.

We appreciate this opportunity to testify before your subcommittee today. We believe that there has been some misunderstanding as to the role of full service banks in determining interest rates, and we are pleased to be here to discuss the issue in some detail.

Full Service Banks

Let me begin by presenting some brief background information on how full service banks operate. Full service banks are financial intermediaries; that is, they borrow money in the form of deposits from groups which have excess funds and they lend this money to households, businesses, and government entities that need additional funds. This financial intermediation is vital to the functioning of our economy; virtually every community in the United States is served by a commercial bank.

Full service banks meet a wide variety of community credit needs including housing finance, non-mortgage consumer finance, agricultural finance, small and large business finance, and government finance. A detailed analysis of each of these activities is attached to this testimony in Tables 1-12. In each lending area, banks compete with other financial institutions. This competition in the financial marketplace insures that no

one lender — or one borrower — can control either the flow of credit or its price.

In many ways, commercial banking is a business like any other business. Banks are owned by private investors, they provide services to meet the demands of their customers and they try to earn a profit. Unlike many other businesses, however, banks are chartered by government authorities, either state or federal. With the charter comes regulation by state and federal agencies.

Rate of Inflation and the High Cost of Credit

Over the last several years, our economy has experienced unprecedented rates of inflation resulting in high and volatile interest rates. Recently, both inflation and interest rates have shown some improvement, but legitimate concerns have been raised about the level of interest rates vis-a-vis the rate of inflation, and about the effects of today's interest rates on economic recovery. Madam Chairman, we all want lower interest rates, and an adequate flow of credit to all sectors of the economy. We firmly believe that the only way to lower interest rates — including consumer interest rates — is to convince the public that the government is firmly and irrevocably committed to maintaining price stability.

The principal point we want to make clear at the outset is that credit markets are highly competitive. Rates for borrowers and lenders are the result of countless daily transactions among market participants ranging from small savers to large corporate borrowers. Each saver/investor weighs his needs for liquidity, safety, and yield and chooses among the array of financial instruments available; borrowers gauge their need for funds and choose among the array of credit instruments available. There are too many

buyers and sellers of financial services for any one bank, savings and loan, credit union, etc. to either obtain funds at rates significantly below those available elsewhere, or to loan funds at rates significantly above those charged elsewhere.

Banks and other financial intermediaries are not the ultimate providers of the funds they lend. As mentioned previously, they simply borrow money in the form of deposits from those with excess funds, and lend to individuals, businesses and government entities who need funds. When the depositors who supply funds to banks demand a high interest rate for the use of their funds, the banks must correspondingly pass this cost along to their borrowers.

In order to understand why these ultimate lenders of funds are demanding rates which appear high compared to current measured inflation, it will be useful to look back over the economic events of the past few years. The United States is just emerging from a prolonged period of economic weakness that began in late 1979. The inflationary cycle beginning in 1978 produced high and volatile interest rates, unacceptably high unemployment and significant dislocations in credit flows. People who put money into fixed rate bonds and/or deposits found the real value of their investments eroded as inflation soared above the yields earned on their investments. The inflationary psychology that grew out of these experiences is firmly entrenched in the public mind, and it will not be easy to reverse. The public has heard Congress after Congress and Administration after Administration promise to restore economic health, reduce inflation and balance the budget. Each time, the public has been disappointed. This unhappy track record has created considerable public skepticism regarding the ability and willingness of the government to follow through with an

anti-inflation program. Until this skepticism is overcome, the outlook for inflation is unclear. This will keep market interest rates stubbornly high vis-a-vis measured inflation as the ultimate lenders demand compensation for the risk of renewed inflation.

Although the measured rate of inflation has receded significantly over the past few months, it is the expected rate of inflation which impacts market interest rates. The prospect of massive federal deficits and huge Treasury borrowing to finance them is serving to keep inflationary expectations significantly above the current measured Consumer Price Index. Federal deficits, including off-budget items, are estimated to be over $200 billion in fiscal years 1984 and 1985, and over $150 billion in fiscal years 1986 and 1987 according to the President's proposed budget. If Congress and the Administration fail to reduce the growth of government spending and the outyear deficits, long-term prospects for interest rates will remain uncertain. This uncertainty has a price in credit markets, as savers and investors demand higher rates for the use of their funds.

Ultimately it is the size of the government's command over resources that preempts healthy growth in the private sector. This preemption occurs in money and capital markets through excessive government borrowing which tends to raise interest rates, and through direct government spending in other markets. The best way to maintain a low rate of inflation and lower interest rates is to reduce prospective budget deficits through reductions in government spending. This will prevent the preemption of resources described above, and will enhance the credibility of policymakers in financial markets. Today there is a substantial fear among financial market participants that taxes will be increased to close the deficit; that the types of taxes to be enacted will be counterproductive and not enhance

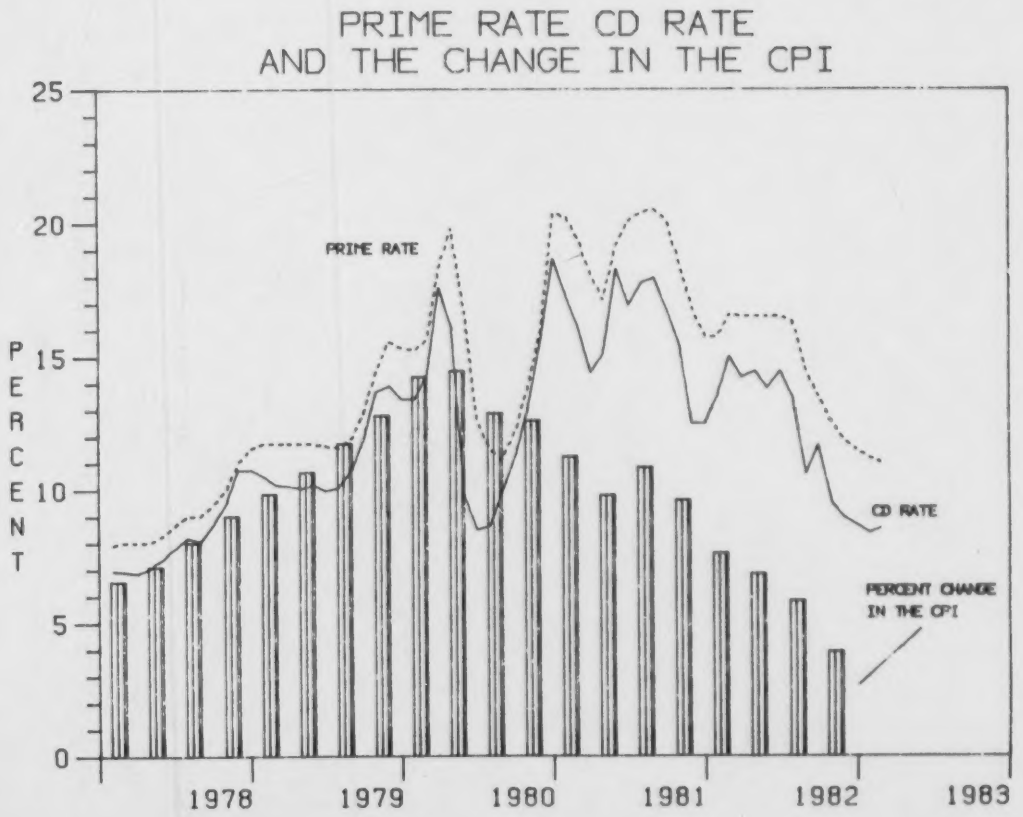
productivity, investment, and growth; and that the level of government spending will be higher than it otherwise would have been. The only road that can be credibly taken is to reduce the deficit by reducing government spending.

These views are based on careful consideration of these issues by our Economic Adivisory Committee, a group of senior level economists at major banking institutions across the country, and are shared by a very large number of bankers. A copy of the statement of the Economic Advisory Committee and a list of the members of the Committee are attached to this statement.

Relationship Between Market Interest Rates and Inflation

The relationship between market interest rates demanded by ultimate lenders and the rate of inflation is shown on Chart 1. The prime rate is used as a proxy for bank lending rates and the CD rate is used as a proxy for the price banks pay to obtain loanable funds. The bars show the quarterly percentage change in the consumer price index as a measure of inflation. The chart indicates that from 1978 until the fourth quarter of 1980, the actual inflation rate apparently exceeded inflationary expectations, because market rates adjusted for inflation were either zero or negative during most of the period. Let me emphasize what this means. People who put money away anticipating that the value of their savings would be greater in the future actually ended up with less purchasing power. By 1981, market rates rose vis-a-vis inflation. And while both the inflation rate and market rates have trended down since 1981, the spread between them has remained high reflecting continuing inflationary expectations and a volatility premium demanded by market participants. The spread between

Chart 1


PRIME RATE CD RATE
AND THE CHANGE IN THE CPI
PERCENT
25
20
15
10
5
0
PRIME RATE
CD RATE
PERCENT CHANGE
IN THE CPI
1978
1979
1980
1981
1982
1983

lending rates as measured by the prime rate and the marginal cost of funds as measured by the large CD rate is far smaller than the spread between measured inflation and the cost of funds. It should be remembered that large CDs are negotiable, and their rates are set in competitive markets. Thus, the spread between the market determined CD rate and measured inflation reflects an inflation premium demanded by the ultimate lenders based on inflationary expectations. For example, on March 7 the gap between the prime rate and the CD rate was about 220 basis points; the gap between the CD rate and the rate of inflation as measured by the CPI* was over 600 basis points.

Commercial loans represent only a portion of the lending business of full service banks; a significant portion of bank loans are made to consumers. Chart 2 shows the average bank rate charged on new auto loans (36 months) as a proxy for an intermediate term consumer loan rate vis-a-vis the CD rate standing for the rate banks pay to get loanable funds. The auto loan rate shows less volatility than the short-term CD rate; during peaks in the CD rate, the auto loan rate actually lies below the rate banks paid to obtain loanable funds. Historically, intermediate and long-term rates have generally adjusted relatively slowly to changes in market rates. This is why during periods of rapidly rising interest rates the yield curve becomes inverted — that is, short-term rates exceed long-term rates. Conversely, as short-term rates fall, intermediate and long-term rates typically fall less quickly. The primary reason for this difference in behavior of short versus long-term rates is based on differences in inflationary expectations. Because experience shows that economic performance follows a cyclical

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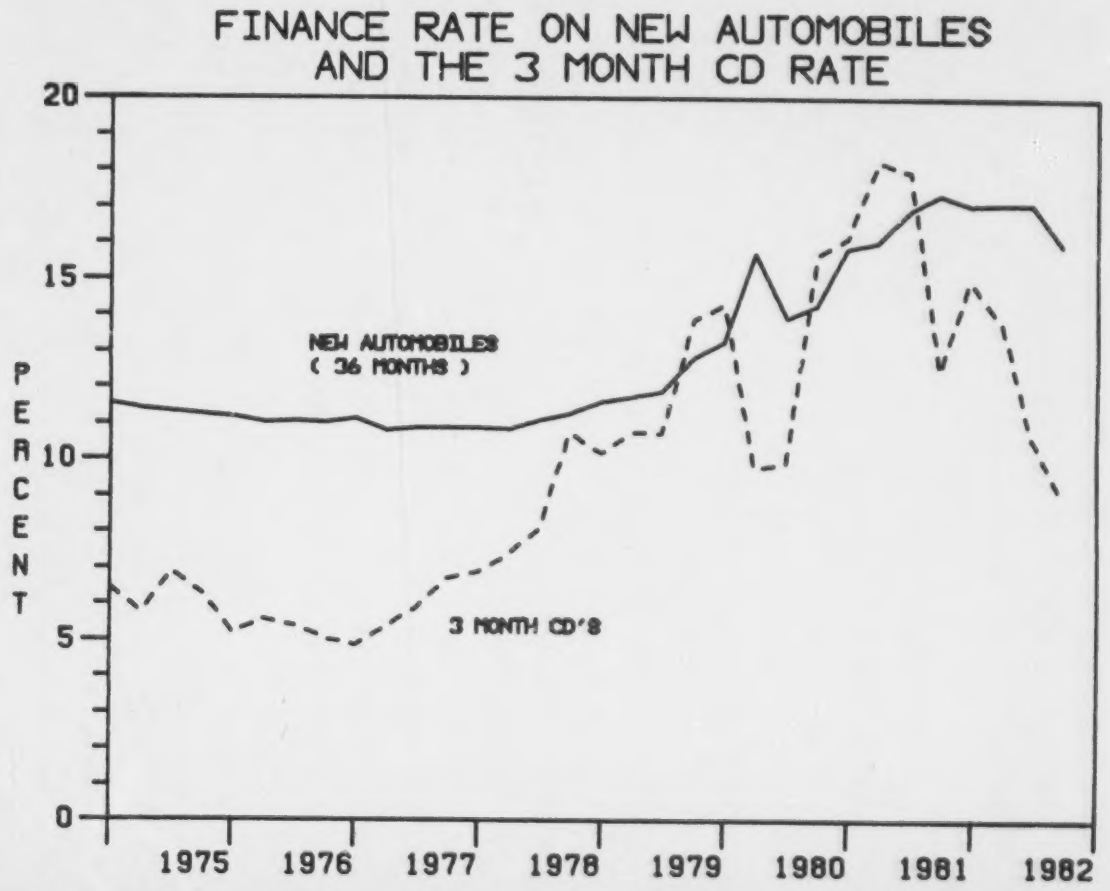
* The most recent annualized CPI figure is 2.4% for January 1983.

Chart 2


FINANCE RATE ON NEW AUTOMOBILES
AND THE 3 MONTH CD RATE
20
15
10
5
0
PERCENT
NEW AUTOMOBILES
(36 MONTHS)
3 MONTH CD'S
1975
1976
1977
1978
1979
1980
1981
1982

pattern, current estimates of long-term inflation rates are likely to be higher than current estimates of inflation over the short run. Longer term inflationary expectations are aggravated by the prospect of large budget deficits which, in combination with potentially strong private demands for credit, will put significant strains on credit markets. There is also greater uncertainty in long range economic forecasting. For example, while you may be fairly comfortable estimating the rate of inflation over the next 30 to 60 days, the probability that your five year forecast will be correct is less certain. Thus, during this part of the rate cycle, investors will demand a larger inflation premium when investing in a long-term instrument than when investing for the short-term.

Impact of Changes in Deposit Structure Resulting From Deregulation

The current inflationary cycle spawned some important innovations in financial markets. For example, the impressive popularity of money market funds with consumers beginning in the late 1970's drained a significant volume of funds away from relatively low rate deposit instruments, as consumers and small businesses sought to protect their purchasing power from erosion by inflation. In 1980, Congress passed the Depository Institutions Deregulation and Money Control Act mandating complete deregulation of deposit rate ceilings by 1986. Substantial deregulation has already taken place, and tremendous shifts of funds have occurred. The percentage of time and savings deposits subject to inflexible rate ceilings — deposits which during past periods of high market interest rates represented "cheap money" — has fallen to less than 30% of total time and savings deposits. The rates paid in the remaining 70% are determined in competitive markets. These changes in deposit structure in response to deregulation, and runoffs

of less expensive consumer-type deposits to money market funds both increased the percentage of deposits paying market rates and shortened the average maturity of deposits. Formerly, depositors who were willing to accept low fixed rate deposits were subsidizing borrowers. This subsidy has been eliminated by deregulation of consumer-type deposits. As a result, the cost of consumer funds more closely approximates market rates than was true in past rate cycles. Essentially, deregulation has merged the consumer market into the money market — and the result is an increase in the cost of bank funds. And when savers/investors demand an inflation premium for the use of their funds, it will be reflected in the cost of borrowing by businesses and consumers alike.

Bank Profitability

Perhaps the most relevant measure of whether banks are indeed somehow holding interest rates artificially high is bank profitability. Complete data on bank profitability for 1982 are not yet available. However, Mr. Harry Keefe of Keefe, Bruyette and Woods, Inc. has selected a sample of 20 banks; the banks were chosen for geographic distribution, and because none has a significant international loan portfolio. Measured 4th quarter 1982 over 4th quarter 1981, interest income minus interest expense as a percent of average earning assets shown in column A of Table 1 — before provision for loan losses — is virtually unchanged.

When loan loss provisions are taken into account, this ratio actually declines by 12 basis points at the 20 banks in the Keefe sample. These loan loss provisions are based on domestic loans, not international loans. In part, domestic loan losses reflect the tremendous strains under which our economy has labored over the past few years engendered by volatile inflation

Table 1

KEEFE, BRUYETTE & WOODS, INC.

February 23, 1983

Company	(A) Net Int. Margin[1]		(B) Loan-Loss Prov'n. / Avg. EA[2]		(A) - (B) Net Funds Function[3] / Avg. EA[2] (C)	(D)	Difference (basis points) (C) - (D)
	4Q'82	4Q'81	4Q'82	4Q'81	4Q'82	4Q'81	
Allied Bancshares	6.18%	6.36%	.73%	.48%	5.45%	5.88%	(43)
Atlantic Bancorp	5.80	5.57	.40	.25	5.40	5.32	8
Banc One	5.70	6.20	.54	.57	5.16	5.63	(47)
BayBanks	6.48	6.42	.19	.36	6.29	6.06	23
Boatmen's	4.37	4.45	.31	.34	4.06	4.11	(5)
Citizens & So. (S.C.)	7.18	7.55	.34	.47	6.84	7.08	(24)
Citizens & So.-Ga.	5.73	5.47	.42	.61	5.31	4.86	45
First Alabama	6.54	6.52	.69	.68	5.85	5.84	1
First American	4.79	4.94	.35	.56	4.44	4.38	6
First Bank System	3.63	3.86	.62	.64	3.01	3.22	(21)
First Kentucky	5.17	4.78	.53	.42	4.64	4.36	28
First Security	6.43	5.89	.78	.03	5.65	5.86	(21)
First Union Corp.	4.84	4.77	.43	.30	4.41	4.47	(6)
First Wisconsin	4.02	3.55	.52	.34	3.50	3.21	29
Lincoln First	5.08	4.95	.38	.36	4.70	4.59	11
Midlantic Banks	5.85	5.73	.58	.30	5.27	5.43	(16)
Rainier	5.32	5.64	.85	.43	4.47	5.21	(74)
State St. Boston	5.45	5.51	.41	.37	5.04	5.14	(10)
U.S. Bancorp	5.18	5.34	1.53	.71	3.65	4.63	(98)
United Virginia	5.47	5.53	.53	.44	4.94	5.09	(15)
Average of 20 Cos.	5.46%	5.45%	.56%	.43%	4.90%	5.02%	(12)

1) Net interest income (fully-taxable equivalent)/average earning assets.

2) Earning Assets

3) Net funds function = Net interest income minus loan-loss provision.

NOTE: All quarterly percentages are on an annualized basis.

and the recession that inevitably followed. A return to economic stability will lower interest rates by reducing both the premium attributable to anticipated inflation, and the premium attributable to anticipated loan losses.

Madam Chairman, in light of recent criticism of bank taxation, let me point out that the loan loss provisions shown on Table 1 are not those permitted by the tax code. They represent provisions for anticipated loan losses based on historical experience and on the best judgment of bank managers and bank regulators. Unfortunately, at this time when bad debt losses are increasing rapidly, the loan loss provision permitted by the tax code is being phased down. We believe that a permanent loan loss reserve for tax purposes of no less than 1% of uninsured loans should be established by this Congress.

Individual Bankruptcy

In part these loan losses also reflect the unprecedented rise in the volume of bankruptcy filings following the enactment of the 1978 Bankruptcy Code. From 1978 to 1982, the number of individual bankruptcies jumped from 172,423 to 449,839 — an increase of 160%.

Concern over this issue prompted the American Bankers Association, in conjunction with numerous other groups representing virtually every other class of consumer creditor in the country, to request the Credit Research Center at Purdue University to analyze this serious and growing problem. The results of that study indicate that a significant number of those individuals who use bankruptcy to discharge their debts are far from "financially destitute." In many cases, these individuals would have been

able to repay most or all of their debts out of disposable income in 3 - 5 years.

Our Association has testified on many occasions on the need for reform of the Bankruptcy Code. Meanwhile, the problems have not gone away. Our members, and all consumer lenders, are faced with a record number of bankruptcies and increasing dollar losses. The impact of the law simply cannot be ignored. It has a direct and adverse effect on bank profitability, which inevitably will affect credit costs for all consumers, since consumers who pay their debts must pay the costs created by consumers who do not.

The losses do not stem from a few isolated examples of abuse, but rather from an increasing trend to use the bankruptcy mechanism to deal with what is essentially affordable consumer debt. In many cases, consumers who have sufficient income to meet their debts are finding that the burden of paying their debts can be more expediently discharged by filing bankruptcy than by altering the lifestyle to which they have become accustomed.

Usury Ceilings

In the midst of the difficulties of bringing inflation under control, usury ceilings may seem to offer a painless way to hasten the return to economic well-being. But a government mandated reduction in interest rates cannot restore economic health; attempts to supersede market forces by government fiat will only complicate an already complex situation. We must not be sidetracked from the pursuit of responsible monetary and fiscal policies which are the only way to achieve lasting economic stability.

Proponents of usury ceilings often mistakenly argue that the issue is simply one of advocating low versus high interest rates. However, usury

ceilings affect the availability as well as the price of credit. These effects are frequently not what the proponents of usury ceilings intend. As the costs incurred by lenders exceed the usury ceiling, the market is constrained from working freely. Faced with restrictive usury ceilings which prevent charging a market rate, creditors have several options. The most obvious adjustment is to decrease credit availability. In this case, small, inexperienced and high risk borrowers will be rationed out of the market; on the other hand, prime borrowers may tend to borrow more than they otherwise would because of the lower rate of interest.

Lenders may also respond to binding usury ceilings by increasing credit related fees. In this case, the explicit rate set by the usury ceiling will lie below the market rate, but the actual rate — including the increased costs — will be higher than the usury ceiling. Adjustments can likewise be made in credit terms; for example, downpayments may be increased, maturities shortened, collateral requirements tightened, minimum loan size requirements might be established, etc. Each of these adjustments reduces the cost to the lender; they also make it more difficult for low income, high risk borrowers to obtain credit.

Lenders may also change the conditions and prices of credit-related items. For example, retail creditors can raise the price of their products to make up for below market rate financing. Creditors who purchase credit instruments from retailers can adjust their terms to lower their risk and/or increase their returns. In this instance, the cost of holding usury ceilings below the market rate will be borne by all consumers in the form of higher retail prices.

Clearly, the impact of binding usury ceilings is disadvantageous to the borrowing public. Moreover, the adverse impact of restrictive usury

ceilings is greatest on the less sophisticated and less affluent borrowers, as well as first time credit seekers. Since these borrowers generally have a higher risk premium, they will either be totally shut off from legitimate credit markets when the cost of credit approaches the usury ceiling, or they will be able to obtain credit only under more stringent terms (e.g. higher dowpayment, shorter maturity, etc.) which they may be less able to handle than a higher rate of interest.

Competition in the Financial Marketplace

The competitive framework within which full service banks operate has expanded beyond traditional depository institutions such as savings and loans, mutual savings banks, and credit unions to include all financial and even some non-financial institutions. A patchwork of federal and state regulation has heavily influenced the degree and form of competition among providers of financial services. For example, artificial restrictions on deposit interest rates resulted in the tremendous growth of money market funds.

While money market funds are a dramatic example of the tremendous competition full service banks currently face, they are by no means the only example. Rapid technological changes, coupled with the regulatory constraints imposed on banks, have encouraged non-bank financial and non-financial firms to offer bank-like services. The lack of regulation of these non-bank firms has allowed some of them to engage in securities services and deposit taking — activities traditionally limited to separate institutions under the Glass-Steagall Act. The result has been a significant blurring of traditional separations of services offered by different types of institutions in financial markets.

If full service banks are to continue to be able to meet community credit needs, they must be allowed to compete with other providers of financial services. The Depository Institution and Deregulation Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982 provide for deregulation of deposit interest rate ceilings as was discussed earlier in this testimony. This giant step toward deregulation of deposits must now be matched by deregulation on the revenue producing side. We have already mentioned the need to remove usury ceilings. In addition, banks must be free to provide expanded financial services to their customers. We believe that consumers of financial services will be best served by healthy competition among many institutions.

Conclusion

In conclusion, I would like to reemphasize our conviction that moderation in interest rates can only be achieved as the by-product of a permanent reduction in the rate of inflation and the winding down of inflation expectations. It is clear that financial markets are not comfortable with long term prospects for inflation, even though the current level of measured inflation is quite low. ABA believes that the economic stability we all seek can best be achieved through consistent pursuit of responsible fiscal and monetary policies. We have supported and will continue to support this approach.

STATEMENT ON THE BUDGET
ECONOMIC ADVISORY COMMITTEE
FEBRUARY 1983

The Administration has based its economic program on four main elements: reductions in the rate of growth of government spending and taxes, monetary policy designed to reduce inflation and a program to reduce the regulatory burden on businesses and individuals. The first two elements directly influence the budget. Reductions in taxes were carried out through the Economic Recovery Tax Act in 1981. However, some of the reductions were eliminated in 1982 by the Tax Equity and Fiscal Responsibility Act (TEFRA). Expenditure reductions were accomplished in the 1983 budget. However, the deficits, including off budget items, are estimated to be over $200 billion in FY 1984 and FY 1985 and over $150 billion in FY 1986 and FY 1987 according to the President's proposed budget.

Our Committee feels that the prospective deficits will result in real interest rates higher than they would have been at lower levels of deficits. These high deficits and increased rates will have adverse effects on the economy which are meaningful and worthy of attention.

To reduce the budget deficits and decrease their adverse effects, expenditure cuts should be used. All sectors of expenditures should be candidates for reduction. Since defense and direct benefit payments for individuals make up 71% of government expenditures in 1984 according to the recommended budget, these areas must be examined closely.

The Committee was skeptical of the benefits of advocating tax increases. Tax increases may have negative impacts on the long run health of the economy and seem to do little to decrease deficits. In particular, our fear is that tax increases, ostensibly to reduce deficits, may shift the political focus away from the need to reduce spending and, in the end, not achieve any real reduction in the deficit. TEFRA, was enacted to decrease budget deficits. After its enactment the estimated budget deficits for the next two years are still over $200 billion. It's actual effect on the deficit is small and it has a negative impact on the prospects for long term growth of the economy by decreasing the incentive to invest.

The Social Security compromise was a small step in the right direction, but it did not go far enough and did not solve the problem of long run viability. There was too much emphasis on increases in taxes rather than reduction in benefits. More work needs to be done on reducing the growth of benefits in the long run.

A most important need for both businesses and individuals is to have consistent tax policies over time so as to facilitate rational financial planning and reduced deficits. The tax system should be structured so as to maximize the amount of funds going to productive investment in the private sector. A healthy, growing private sector of the economy can best be facilitated by significant reductions in government spending so as to free up real resources for private investment.

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TABLE 1

HOUSING FINANCE

Residential Mortgage Loans Outstanding by Type of Lender
June 1982
(Billions of Dollars)

Lender	One-to-Four Family	Pct. of Total	Multi-Family	Pct. of Total	Total	Pct. of Total
Savings and Loans	$415.9	45.3	$37.2	30.7	$453.1	43.6
Full Service Banks	155.5	16.9	7.1	5.9	162.6	15.6
Mortgage Pools or Trusts	150.8	16.4	10.4	8.6	161.2	15.5
Federal & Related Agencies	73.9	8.1	16.9	13.9	90.8	8.7
Mutual Savings Banks	66.7	7.3	14.0	11.5	80.7	7.8
Life Insurance Companies	16.5	1.8	18.5	15.3	35.0	3.4
All Others	38.6	4.2	17.1	14.1	55.7	5.4
Total	$918.0	100.0%	$121.3	100.0%	$1039.3	100.0%

Source: HUD News No. 82-177, September 8, 1982.

Measuring the Banking Industry's Contribution to Housing

Residential Mortgage Loans	$162.6 billion
Obligations of Federal Housing Agencies 2/	32.3
Mobile Home Loans 1/	9.9
Residential Construction Loans	18.9
Home Improvement Loans	8.4
Loans to Other Housing Lenders	22.5
Municipal Securities Supporting Housing 3/	102.3
	$356.9 billion

1/ Also included in Non-Mortgage Consumer Finance
2/ Also included in Government Finance
3/ Total holdings included in Government Finance

Sources: HUD News No. 82-177, September 8, 1982, Department of Housing and Urban Development; Treasury Bulletin, August 1982; FDIC and Municipal Market Developments, Public Securities Association, February 1982.

TABLE 2

NUMBER OF INSURED FULL SERVICE BANKS DISTRIBUTED BY SIZE AND BY RATIO OF RESIDENTIAL MORTGAGE LOANS TO TOTAL ASSETS JUNE 30, 1982

Ratios (in Percent)	Asset Size (in millions of dollars)								
	< 5.0	5.0-24.9	25.0-99.9	100.0-149.9	150.0-299.9	300.0-999.9	1,000.0-4,999.9	5,000-more	All
< 5.0	293	2241	1392	144	134	99	51	15	4369
5.0-9.99	87	1508	1593	202	146	107	61	16	3720
10.0-14.99	45	917	1218	173	124	98	31	2	2608
15.0-19.99	18	619	854	135	103	59	22	3	1813
20.0-24.99	14	375	569	60	52	22	6	1	1099
25.0-29.99	3	200	254	21	22	2	0	0	502
30.0-34.99	2	92	103	11	3	3	0	0	214
35.0-39.99	1	38	26	4	2	0	0	0	71
40.0-44.99	0	17	10	2	2	0	1	0	32
45.0-49.99	0	7	1	2	0	0	0	0	10
50.0-more	3	4	4	0	0	0	0	0	11
TOTAL	466	6018	6024	754	588	390	172	37	14,449

Source: Federal Deposit Insurance Corporation.

TABLE 3

NUMBER OF INSURED FULL SERVICE BANKS DISTRIBUTED BY SIZE AND BY RATIO OF TOTAL REAL ESTATE LOANS TO TOTAL ASSETS JUNE 30, 1982

Ratios (in Percent)	Asset Size (in millions of dollars) <5.0	5.0-24.9	25.0-99.9	100.0-149.9	150.0-299.9	300.0-999.9	1,000.0-4,999.9	5,000-more	All
< 5.0	191	950	367	29	23	16	13	6	1595
5.0-9.99	93	1261	712	43	46	45	26	9	2235
10.0-14.99	69	1101	1095	118	98	72	46	8	2607
15.0-19.99	57	900	1203	183	125	102	36	9	2615
20.0-24.99	29	710	1020	181	142	76	27	2	2187
25.0-29.99	8	508	789	106	76	49	17	2	1555
30.0-34.99	8	330	481	45	43	17	4	0	928
35.0-39.99	6	146	230	27	21	6	1	1	438
40.0-44.99	2	66	86	14	11	5	0	0	184
45.0-49.99	0	29	29	6	1	2	0	0	67
50.0-more	3	17	12	2	2	0	2	0	38
TOTAL	466	6018	6024	754	588	390	172	37	14,449

Source: Federal Deposit Insurance Corporation.

TABLE 4

CONSUMER FINANCE
(Non-Mortgage)

Consumer Instalment Credit
By Holder
June 1982
(Billions of Dollars)

Holder	Amount Outstanding	Percentage of Total
Full Service Banks	$146.8	44.2%
Finance Companies	93.0	28.0
Credit Unions	45.9	13.9
Retailers*	26.6	8.0
Savings and Loans	12.3	3.7
Gasoline Companies	4.4	1.3
Mutual Savings Banks	2.8	.8
Total	$331.9	100.0%

* Includes auto dealers and excludes 30-day charge credit held by travel and entertainment companies.

Source: Federal Reserve Bulletin, November 1982.

Banking's Contribution to Consumer Finance
(Non-Mortgage)
June 1982
(Billions of Dollars)

Type of Credit	Amount Outstanding
Auto Loans	$58.1
Revolving Credit	32.0
Mobile Home Loans 1/	9.9
Other Instalment Credit	46.7
Single-Payment Loans	37.5
Total	$184.2

1/ Also included in Housing Finance

Sources: Federal Deposit Insurance Corporation and Federal Reserve Bulletin, November 1982.

TABLE 5

NUMBER OF INSURED FULL SERVICE BANKS DISTRIBUTED BY SIZE
AND BY RATIO OF CONSUMER (NON-MORTGAGE) LOANS TO TOTAL ASSETS
JUNE 30, 1982

Ratios (in Percent)	Asset Size (in millions of dollars)								
	< 5.0	5.0-24.9	25.0-99.9	100.0-149.9	150.0-299.9	300.0-999.9	1,000.0-4,999.9	5,000 or more	All
< 5.0	138	1114	562	51	60	43	26	13	2007
5.0-9.99	139	1765	1807	191	169	96	45	14	4226
10.0-14.99	85	1302	1671	231	162	129	59	9	3648
15.0-19.99	43	827	1017	150	112	69	31	1	2250
20.0-24.99	35	519	526	81	49	35	8	0	1253
25.0-29.99	9	240	255	26	26	10	1	0	567
30.0-34.99	9	131	108	11	9	3	0	0	271
35.0-39.99	4	65	45	7	0	2	0	0	123
40.0-44.99	4	37	15	3	0	2	0	0	61
45.0-49.99	0	10	9	0	0	0	0	0	19
50.0-more	0	8	9	3	1	1	2	0	24
TOTAL	466	6018	6024	754	588	390	172	37	14,449

Source: Federal Deposit Insurance Corporation.

TABLE 6

AGRICULTURAL FINANCE

Farm Debt Outstanding by Type of Lender 1/
End of Second Quarter 1982

Lender Group	Billions of Dollars	Pct. of Total
Full Service Banks	$44.2	27.3%
Farm Credit System	69.2	42.7
Farmers Home Administration	25.3	15.6
Life Insurance Companies	13.0	8.0
Commodity Credit Corporation	10.5	6.5
Total	$162.1	100.0%

1/ Total does not include farm debt outstanding held by individuals and others which amounted to $43.3 billion at the end of 1981.

Source: Agricultural Finance Databook, Federal Reserve Board, September 1982.

FULL SERVICE BANK HOLDINGS OF FARMERS HOME ADMINISTRATION
AND FARM CREDIT SYSTEM SECURITIES 1/
JUNE 30, 1982
(BILLIONS OF DOLLARS)

Banks for Cooperatives	$0.2
Farm Credit Banks	11.4
Federal Intermediate Credit Banks	0.7
Federal Land Banks	2.0
Total	$14.3

1/ Also included in Government Finance

Source: Treasury Bulletin, August 1982, TSO - 4 & 5.

TABLE 7

NUMBER OF INSURED FULL SERVICE BANKS DISTRIBUTED BY SIZE
AND BY RATIO OF AGRICULTURAL LOANS TO TOTAL ASSETS
JUNE 30, 1982

Ratios (in Percent)	Asset Size (in millions of dollars)								
	<5.0	5.0-24.9	25.0-99.9	100.0-149.9	150.0-299.9	300.0-999.9	1,000.0-4,999.9	5,000-more	All
< 5.0	151	2288	3581	615	530	369	166	37	7737
5.0-9.99	61	796	813	76	41	14	6	0	1807
10.0-14.99	48	658	555	35	10	4	0	0	1310
15.0-19.99	50	572	419	21	4	1	0	0	1067
20.0-24.99	49	497	258	3	0	1	0	0	808
25.0-29.99	27	374	172	3	3	1	0	0	580
30.0-34.99	27	296	90	1	0	0	0	0	414
35.0-39.99	20	221	64	0	0	0	0	0	305
40.0-44.99	17	141	35	0	0	0	0	0	193
45.0-49.99	6	96	28	0	0	0	0	0	130
50.0-more	10	79	9	0	0	0	0	0	98
TOTAL	466	6018	6024	754	588	390	172	37	14,449

Source: Federal Deposit Insurance Corporation.

TABLE 8

SMALL BUSINESS FINANCE

Salient Facts

- As of June 30, 1981, small business loans accounted for a third of the estimated $360 billion of business loans outstanding at banks.
- Small banks (assets less than $100 million) and medium-sized banks (assets $100 million up to $1 billion) hold most of the small-business bank credit.
- The majority of small business loans are made by urban banks.
- At the end of the 1981 fiscal year, 10,536 full service banks had at least one SBA loan outstanding. Of that total, over 1700 banks had between 10-24 loans,and close to 700 banks had 25 or more loans each.
- At the end of 1981, 57 of the 362 licensed Small Business Investment Companies (SBICs) were bank controlled (50 percent or more owned by a bank or bank holding company) and 12 were bank associated (10 percent to 49 percent owned by a bank or bank holding company). Thirteen of the 130 301(d) SBICs (limited to assisting small business concerns owned by socially or economically disadvantaged persons) were also either bank controlled or bank associated.

Sources: Studies of Small Business Finance, The Interagency Task Force on Small Business Finance, February 1982, and the Small Business Adminstration.

Source of Most Recent
Small Business Loan [1/]
(April 1982)

Bank	91%	Co-op	1%
Private Person	4%	S & L	1%
Government	0	Other	2%
Finance Co.	1%		
Insurance Co.	0		

[1/] non-borrowers and no answers excluded.

Source: National Federation of Independent Business.

TABLE 9

LARGE BUSINESS FINANCE

Bank and Commercial Paper Borrowing in Past 12 Months
By Company Size and Industry Group
(Billions of Dollars)

	Bank Borrowing	Pct. of Total	Commercial Paper Borrowing	Pct. of Total
Fortune Rank				
1-200	$10.7	19.0%	$21.3	20.2%
201-500	7.1	12.6	4.7	4.5
501-1000	7.5	13.3	.6	.6
Industry Group				
Financials	7.7	13.7	9.8	9.3
Insurance	.8	1.4	.8	.8
Retail	1.3	2.3	14.1	13.4
Transportation	2.7	4.8	.6	.6
Utilities	7.9	14.1	9.9	9.4
Finance Companies	3.0	5.3	38.8	36.9
Wholesale Trade	3.0	5.3	2.4	2.3
Private	4.6	8.2	2.2	2.1
Total Companies	$56.2	100.0%	$105.2	100.0%

Source: Large Corporate Banking, Greenwich Research Associates, 1982.

U.S. and Foreign Bank Coverage
By Company Size

	Banks Used		Banks Soliciting		Bank Coverage	
Fortune Rank	U.S.	Foreign	U.S.	Foreign	U.S.	Foreign
1-100	35.4	8.4	9.7	4.7	45.1	13.1
101-200	23.1	4.3	12.1	6.3	35.2	10.6
201-300	17.2	2.9	12.9	6.3	30.1	9.2
301-400	13.0	1.8	11.2	5.1	24.2	6.9
401-500	11.9	2.1	12.8	4.6	24.7	6.7
501-600	9.6	1.4	13.5	4.6	23.1	6.0
601-700	7.6	1.3	10.8	3.7	18.4	5.0
701-800	7.6	1.2	11.2	2.9	18.8	4.1
801-900	7.3	1.2	8.5	2.2	15.8	3.4
901-1,000	6.1	0.6	10.7	3.0	16.8	3.6
Total companies	15.5	2.7	10.1	3.8	25.6	6.5

Note: U.S. bank coverage is based on the top 85 banks and foreign bank coverage on 25 foreign banks.

Source: Large Corporate Banking, Greenwich Research Associates, 1982.

Table 10

NUMBER OF INSURED FULL SERVICE BANKS DISTRIBUTED BY SIZE
AND BY RATIO OF COMMERCIAL AND INDUSTRIAL LOANS TO TOTAL ASSETS
JUNE 30, 1982

Ratios (in Percent)	Asset Size (in millions of dollars) < 5.0	5.0-24.9	25.0-99.9	100.0-149.9	150.0-299.9	300.0-999.9	1,000.0-4,999.9	5,000-more	All
< 5.0	203	1612	845	56	27	10	3	0	2756
5.0-9.99	117	1842	1682	154	109	49	10	1	3964
10.0-14.99	64	1102	1379	178	139	100	34	1	2997
15.0-19.99	40	617	875	156	113	98	49	5	1953
20.0-24.99	16	361	531	90	87	60	36	9	1190
25.0-29.99	11	199	326	56	51	34	18	10	705
30.0-34.99	6	127	204	26	30	18	12	6	429
35.0-39.99	3	76	103	20	17	8	7	2	236
40.0-44.99	2	43	45	12	10	8	1	0	121
45.0-49.99	3	17	19	3	3	2	0	2	49
50.0-more	1	22	15	3	2	3	2	1	49
TOTAL	466	6018	6024	754	588	390	172	37	14,449

Source: Federal Deposit Insurance Corporation.

Table 11

GOVERNMENT FINANCE

Privately Held Gross
Public Debt of
U.S. Treasury
By Holder
June 1982
(Billions of Dollars)

	Amount Outstanding	Percentage of Total
Full Service Banks	$117.0	15.8
State and Local Governments	91.2	12.3
Individuals (Savings Bonds)	67.4	9.1
(Other Securities)	78.8	10.6
Other Companies	38.9	5.3
Insurance Companies	22.2	3.0
Mutual Savings Banks	5.7	.8
Foreign and International 1/	141.9	19.2
Other Miscellaneous Investors 2/	177.8	24.0
Total	$740.9	100.0%

1/ Consists of investments of foreign balances and international accounts in the U.S.

2/ Includes savings and loans, nonprofit institutions, corporate pension trust funds, dealers and brokers, certain government deposit accounts, and government sponsored agencies.

Source: Federal Reserve Bulletin, November 1982.

Table 11

-2-

Estimated Bank Holdings
of
Securities Issued
By Government Agencies and
Government-Sponsored Agencies
June 30, 1982
(Billions of Dollars)

Agency	Estimated Bank Holdings	Percentage of Total Agency Securities Outstanding
Federal National Mortgage Assoc. 1/	$15.6	24.9%
Farm Credit Administration 2/	14.3	19.4
Federal Home Loan Banks 1/	15.0	24.2
Federal Home Loan Mortgage Assoc. 1/	1.3	4.1
Government National Mortgage Assoc. 2/	.4	19.8
Other	.1	5.3
Total	$46.7	20.3%

1/ Also included in Housing Finance
2/ Also included in Agricultural Finance.

Source: Treasury Bulletin, August 1982.

Banking's Contribution to
Government Finance
(Billions of Dollars)

Securities	Amount Outstanding
U.S. Treasury	$117.0
U. S. Government Agency and Corporation	46.7
State and Local Government 1/	150.2
Total	$313.9

1/ Housing-related securities included in Housing Finance.

Sources: Federal Reserve Bulletin, Treasury Bulletin, and Federal Deposit Insurance Corporation.

TABLE 12

NUMBER OF INSURED FULL SERVICE BANKS DISTRIBUTED BY SIZE
AND BY RATIO OF AGRICULTURAL LOANS TO TOTAL ASSETS
JUNE 30, 1982

Ratios (in Percent)	Asset Size (in millions of dollars) <5.0	5.0-24.9	25.0-99.9	100.0-149.9	150.0-299.9	300.0-999.9	1,000.0-4,999.9	5,000-more	All
< 5.0	151	2288	3581	615	530	369	166	37	7737
5.0-9.99	61	796	813	76	41	14	6	0	1807
10.0-14.99	48	658	555	35	10	4	0	0	1310
15.0-19.99	50	572	419	21	4	1	0	0	1067
20.0-24.99	49	497	258	3	0	1	0	0	808
25.0-29.99	27	374	172	3	3	1	0	0	580
30.0-34.99	27	296	90	1	0	0	0	0	414
35.0-39.99	20	221	64	0	0	0	0	0	305
40.0-44.99	17	141	35	0	0	0	0	0	193
45.0-49.99	6	96	28	0	0	0	0	0	130
50.0-more	10	79	9	0	0	0	0	0	98
TOTAL	466	6018	6024	754	588	390	172	37	14,449

Source: Federal Deposit Insurance Corporation.

Senator HAWKINS. Thank you, Mr. Kennedy.

INNOVATION OF REVOLVING CREDIT

Would you agree or disagree with the statement that the innovation of revolving credit and the development of the credit card itself cut the cost of providing credit to the consumer?

Mr. KENNEDY. Cut the cost? No, ma'am. I think the cost of that type of credit is probably higher than any other type of credit, both in terms of the credit risk involved and also in terms of the operational costs of credit card operations.

Senator HAWKINS. Why, then, are so many banks sending out this rash of cards to new people, asking them to sign up?

Mr. KENNEDY. Because they are trying to provide services for their customers. It has been our experience over the years that credit card usage is extremely popular with the population regardless of the cost of it.

Senator HAWKINS. Why would you be in the business if it is a loss to the industry?

Mr. KENNEDY. As far as I am concerned, I sold my credit card operation last year, and the reason I did it is because we were losing money on it.

I noticed in the paper this morning, as did you, that some retail stores in Virginia are raising their financing charge to 21 percent, and I presume that is a result of credit card losses in the past. But I am not familiar with that problem.

Senator HAWKINS. As President of the ABA, you don't know of any reasons why the banks are doing this other than what you told me—just to attract more bad risks?

Mr. KENNEDY. I wouldn't call them all bad risks. By far the largest proportion of people are good credit risks. You have some deadbeats, as you would expect, and also, when the economy turns down on you, you have some unexpected risk. And that is what we have been experiencing for the last two years, as you know.

Senator HAWKINS. Is there any screening of these people that you mail the cards to—the person that didn't ask for it?

Mr. KENNEDY. I believe under the law we are now required to have a credit application before you send the cards out, Madam Chairman. That goes several years back.

Mr. O'CONNOR. Madam Chairman, as manager of a credit card operation, I don't pretend to be able to speak for the banks in question as to their absolute rationale, but as Mr. Kennedy alluded to, the credit card business is a tremendously expensive business to operate in terms of costs, both fixed and variable. Further, it has been a given in the credit card business over the years that it is a volume-driven business.

There are economies of scale generated. It is a low margin business. In fact, for the last several years it has been a nonmargin business, and I suspect that some of the intentions of these mass mailing campaigns are directed at generating volume to disburse the fixed costs of the basic credit card operation over a bigger number of cardholders.

Senator HAWKINS. It is your understanding that before an individual receives one of these cards in the mailings that they have filled out a credit application?

Mr. O'CONNOR. It depends on how you define a credit application. Most of the mailings that are being done are what are called "prescreened mailings."

Senator HAWKINS. People already have a card with some other company?

Mr. O'CONNOR. They have a credit history of some sort.

Senator HAWKINS. Do they have access to that?

Mr. O'CONNOR. Through a credit reporting agency, a computerized basis, not the individual record per se, but a name and address of an individual that might meet your criteria, whatever those would be—length of time at a residence or a number of references and a good credit history.

And again, it is hard to define the application. Generally from these inmailings, a side document results that accepts the offer and may or may not contain other demographic type information.

I think legally that is defined as an application. It is not your classic application that a visitor to a branch might fill in.

Senator HAWKINS. In your opinion, Mr. Kennedy, is there anything banks can do to help lower interest rates? Is it all the Federal Reserve's fault?

Mr. KENNEDY. Madam Chairman, we are just as interested in having interest rates come down as is Congress. The basic problem, in our opinion, as my testimony indicated, is the fact that the public perception of what is taking place right now is that we are likely to have more inflation, and as long as that feeling persists we are going to continue to have interest rate protection, that is inflation protection in the interest rate structure.

If Congress and the administration can get a handle on the Federal budget and we can begin to see a downturn in the amount of debt, then I think you will begin to see that inflation driven by the economy, and interest rates will begin to come down. But if you look at the profit picture on banks, I think you will find that it is not excessive in any way, shape, or form and, in fact, somewhat to the contrary.

I would submit to you that the profit picture is an indication that there is no profiteering going on as far as the banking industry is concerned.

Senator HAWKINS. Well, the public has the perception that the small businessman and the consumer are charged high interest rates to compensate for lower interest rates and the losses from loans to insiders or to favored corporate customers.

The perception lately has been heightened by articles that have been written in newspapers. There is one in Wednesday's Wall Street Journal entitled "The Butcher Family," telling how Butcher and associates had 50 percent of the problem loans at United American, the Tennessee bank that we all know failed.

Is inside lending at low rates a common practice in the banking industry?

Mr. KENNEDY. Absolutely not, not in my experience. Now, obviously there comes a bank every now and again, such as Penn Square, or such as United American Bank in Knoxville.

But I want to remind you, if I may, that there are 14,500 banks in this country of all sizes and shapes, and by far the majority are properly run, correctly administered, properly regulated, and there is a very, very small amount of that type of thing taking place.

I don't have it in my record, but I was looking this morning at some of the historical evidence that relates to the difference between the prime rate and auto finance loan rates, not bank finance to automobile rates.

The difference in 1953 was about 7.64 percent, as I recall it, between the prime rate and the automobile finance rate; and in 1962 it was 7.53, or something of that nature. So what we have here is a historical pattern of rates in this industry that we are beginning to recur.

If you will look at the sheet over there, you will notice that the credit card rate was relatively flat. It might have been too high, in your opinion, but it was flat. So was the automobile finance rate.

And the cost of funds went up, and the charges to the large customers came down from that 7½ percent rate I was talking about, and now that is beginning to be resumed. And that is one of the things we are looking at out there today.

Senator HAWKINS. Do practices such as occurred at the Tennessee bank having any effect on the consumer structure?

Mr. KENNEDY. Infinitessimal, if any. Loan losses are always a cost of doing business, and if you have excessive loan losses for any reason at a particular individual bank, I would think that they would try to cover the costs, because profits is what keeps us all going,

But when you look at the big picture, if that particular bank got out of hand on its pricing, the competition will eat them alive. That's the beauty of the free market system.

Senator HAWKINS. You've heard some testimony this morning or some comments that there may or may not be any influence on the interest rates because of the foreign loans that have been made imprudently to be extended indefinitely.

Do you think that has an effect?

Mr. KENNEDY. I find it extremely hard to believe that it has any effect. In the first place, this gentleman will testify, if the 200 or so banks who are in the foreign loan business out of 14,500 got in a posture and increased their rates to cover that cost, their competitors who are not in the foreign lending business would eat them alive; they just wouldn't be competitive.

So I don't believe that.

Senator HAWKINS. Are there examples of that? Can you give me an example of a bank that's not in the foreign lending business that is charging a lesser rate of interest than a bank that is in the foreign lending business?

Mr. KENNEDY. No, ma'am, I haven't seen those figures.

Senator HAWKINS. Is there a way to get them?

Mr. KENNEDY. I am sure that we'd be glad to check into it for you.

Senator HAWKINS. Would you do that in response? Thank you so much.

I have no other questions for you, Mr. Kennedy. I want you to catch your plane.

Mr. KENNEDY. Thank you very much, Madam Chairman. I want to apologize again to my associates here, but I appreciate this opportunity.

Senator HAWKINS. Thank you. Now, Mr. Durkin, we'll resume with you. I apologize again for interrupting you.

Mr. DURKIN. That's quite all right, Madam Chairman.

The sharp flucations in market interest rates in recent years have increased public attention to the course of financial markets and the behavior of financial institutions. And, as history so frequently records, when the public is uneasy about forces like interest rates that it considers mysterious, support develops for simple theories that unfavorable events are caused by someone with sinister motives. Unfortunately, an explanation of trends in consumer loan interest rates in financial institutions is not quite so simple.

MAKING PERSONAL LOANS

However, rather than speaking today about the generalities of complex interest rate theory, I would prefer to speak more about the particular experience of finance companies making personal loans. In selling their lending products, finance companies, along with other financial institutions, must charge rates high enough to cover all costs and earn an acceptable return; otherwise, the business will fail or capital will be reallocated to more promising enterprises. Thus, in their pricing decisions finance companies and others must give great weight to the cost of borrowed funds, to office operating costs, to default and bankruptcy costs, and to taxes and adequate return on invested capital. Covering costs and earning an adequate return does not mean that the finance companies or anyone else can simply charge whatever they please. In the same way that competition with other supermarkets in the corner store limits the options of grocers, competition with 2,000 large and small finance companies and 40,000 other depository institutions limits the charges asked by any lender.

The chart attached to my statement illustrates a 5-year experience of 26 large members of the American Financial Services Association that account for more than half of all finance company personal loans. Because of their importance in the industry, these companies provide an excellent sample to use in studying industry trends.

The top line in this chart illustrates the gross revenues of these 26 companies relative to their yearend domestic receivables. These revenues include not only domestic interest income but also revenues from other sources including insurance and foreign and miscellaneous sources.

The distance between the top line in the chart and the dotted line is these companies' costs of borrowed funds relative to domestic receivables. The widening space in the chart over the years clearly illustrates the escalating costs of borrowing funds from 1977 to 1981. Although these companies maintain substantial portions of their liabilities in long-term form, this does not immunize them to increases in market costs of funds. As may be seen on the chart

and the table, the cost of funds rose rapidly from 6 percent of receivables in 1977 to 11 percent in 1981. In order to continue paying their operating expenses and to earn a reasonable return on investment as funds costs rose, companies were forced to look for offsets during these years, including both higher charges and lower expenses wherever possible.

Subtracting the costs of borrowed funds from gross revenues yields gross margins available for operating expenses including losses, for taxes, and for profits. This gross margin in relation to receivables may be seen as the shaded area in the chart. Rather than a rising margin over time, the chart shows a relatively steady margin before a substantial drop in 1981. In 1981 these companies were unable to cover any of their higher funds costs through higher gross return on receivables. The result was a substantial squeeze on gross margin and sharp pressure on profits.

Unfortunately, 1982 results have not yet been received from member companies and compilations will not be available for some months. Nevertheless, subject to revision as the data become available, a few likely features seem predictable.

First, average borrowed funds costs in relation to receivables may have dipped somewhat in 1982, although this is not at all certain. This result is unclear because average long-term corporate bond rates in 1982 closely approximated 1981 average rates, even though the trend was downward. And, as old low cost long-term debt continues to run off, it still must be refunded at rates higher than in the 1950's and 1960's. Short-term rates did fall in 1982 compared to 1981, but they fell sharply only in the second half of the year. The full year average was still very high by historical standards.

Second, it seems likely that firms probably attempted to maintain or raise charges wherever possible in 1981 in order to restore gross margins to historical levels. Of course, increasingly competitive consumer loan markets may have forestalled this opportunity for many companies. Combining these revenue and funds cost pictures, it seems likely that gross margins remained low by historical standards in 1982.

Third, it seems reasonable that the sharp cost cutting begun in 1981 continued in 1982. Faced by escalating funds costs, sharply higher losses due to personal bankruptcies, inflation in salaries, rent, utilities, and social security taxes and shrinking profit margins, personal loan firms speeded up the pace of change in their business in 1981.

BANKRUPTCY SITUATION

In this context the bankruptcy situation deserves special mention. Sharply higher personal bankruptcies since 1979 have aggravated the squeeze caused by shrinking gross margins. This has slowed the decline in consumer loan interest rates, as well as forced fundamental changes in industry operations. Secured personal loans in the 26 companies considered in the chart reached half of personal loans in 1981, up from only one-seventh in 1977, and 38 percent as recently as the year before. Even so, the 19 companies able to supply the information reported more than 40 per-

cent of their losses in 1981 were due to bankruptcies. We have no historical information to compare this with, but members tell us that bankruptcy losses have doubled over only a few years. Reflecting the profit squeeze and the change in business, the 26 companies closed a sixth of their offices nationwide in 1981. Furthermore, their number of employees declined 14 percent after years of annual increases. After all these changes it seems possible that net profits may have improved a little in 1982 compared to 1981.

In sum, available evidence on fianance companies does not support the hypothesis that they're keeping rates high to widen the margins compared to the historical experience. Higher funds costs have force finance companies to look for new revenues in recent years, but margins still have narrowed rather than widened. While it seems likely that firms in 1982 probably attempted to increase margins over the year before, 1981 margins were very narrow by historical standards, and it's not at all clear that firms would have been able to widen them very much. As a result, it seems probable that drastic cost cutting continued in 1982 along with the maintenance of the longer-term credit toward a more profitable product mix.

AFSA thanks the committee for the opportunity for expressing these views on these important issues. I am ready to answer any questions you may have.

[The complete statement follows.]

Statement of

Thomas A. Durkin

Director of Research

American Financial Services Association

My name is Thomas A. Durkin. I am Director of Research of the American Financial Services Association (AFSA) [1/] and Adjunct Senior Research Associate in Finance at the Pennsylvania State University. I welcome the opportunity to participate in this hearing and to offer AFSA's views on consumer loan interest rates.

The sharp fluctuations in market interest rates in recent years have increased public attention to the course of financial markets and the behavior of financial institutions. Most recently, the sharp declines in short-term market rates since the summer of 1982 have raised for discussion a number of important issues including 1) why rates rise and fall in the first place; 2) why some rates rise and fall more than others; and 3) why there are timing differences in the fluctuations of different interest rates. The answers to these questions are difficult and complex, although economic theory provides the analytical framework. But, because economic conditions are constantly changing and economic science does not offer controlled laboratory environments like the physical sciences, predictions of the

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1/ Organized in 1916, AFSA is the national trade association of companies engaged in the consumer credit business. AFSA represents over 580 companies operating more than 15,000 offices serving the public throughout the country. The membership of AFSA is highly diversified ranging from single, small loan offices to very large international financial services organizations engaged in providing a variety of financial products to consumers and business. The finance industry accounts for over one-fourth of all consumer credit outstanding, or approximately $94 billion of the $343 plus billion outstanding.

economic future are chancy. This fact only heightens existing public fears and uneasiness about the economic situation. And, as history so frequently records, public uneasiness about mysterious forces often leads to simple theories that unfavorable events are caused by someone's sinister motives. Unfortunately, explanation of trends in consumer-loan interest rates at financial institutions is not quite so simple.

Determination of Interest Rates

Fundamentally, interest is, of course, the price that those who need additional current resources are willing to pay to have them made available. Interest is paid to those with saved resources they are willing to lend - usually, in our economy, through financial institutions. Thus, financial institutions are conduits or intermediaries that channel resources from savers to borrowers, returning the interest borrowers are willing to pay and which savers require.

In an economy like ours with financial markets and institutions, the price of credit is determined like the price of anything else - by supply and demand in free markets. For any given supply of resources by savers, interest rates will rise if the demand for borrowing rises. Likewise, interest rates will fall if the demand for borrowing falls. Very simply, then, the interest rate at any time is the price of credit that just balances supply and demand.

Any deviation of supply or demand from this balance will cause interest rates to move up or down.

In such a complex economy with many potential suppliers and borrowers of current resources, there is constant, active competition for funds. And, savers and intermediaries with resources to lend have become pretty sophisticated. They are not willing to lend to all on the same terms. Instead, they demand different compensation depending on risk, maturity, and amounts of costs involved in credit checking, bookkeeping, and operations. Furthermore, and most importantly, they also demand compensation for expected inflation. If prices of goods and services in the economy are expected to rise 6 percent in a year, suppliers of current resources are hardly likely to supply them for a 3 percent rate of interest. Rather, they will require an inflation premium on top of their usual interest requirement. If, for example, their requirement for lending in a noninflationary economy is 3 percent, then if prices are expected to rise by 6 percent a year, resource providers will logically require 9 percent annual compensation. This is apart from the need to cover operating costs and the cost of risk.

Although this theory is well known, what is often overlooked is that current inflation and expected inflation are not necessarily the same at a point in time. Thus, if savers' requirement is a 3 percent real return and current inflation is at a 2 percent rate, this does not mean they

will lend at 5 percent if they expect inflation to accelerate. Rather, before they lend they will add their own inflation expectation to their real-rate requirement. Consequently, since current inflation and expected inflation are not the same, subtracting current inflation from market interest rates does not yield useful conclusions about whether real rates are "too high." If the 9 percent rate in the example proves too high, or if others have lower expectations of inflation, they will bargain down market interest rates by offering lower terms.

Specific Experience of Finance Companies

As I mentioned, though it is complex, the basis of interest-rate theory is well known. As a result, I would prefer today to speak more about the particular experiences of finance companies making personal loans. In pricing their lending products finance companies, along with other financial institutions, must charge rates high enough to cover all costs and earn an acceptable return. Otherwise, the business will fail or capital will be reallocated to more promising enterprises. Thus, in their pricing decisions finance companies and others must give great weight to costs of borrowed funds, office operating costs, default and bankruptcy costs, taxes, and adequate return on invested capital. Of course, covering costs and earning an adequate return does not mean finance companies or anyone else can simply charge whatever they please. In the same way that competition with other supermarkets and the corner store

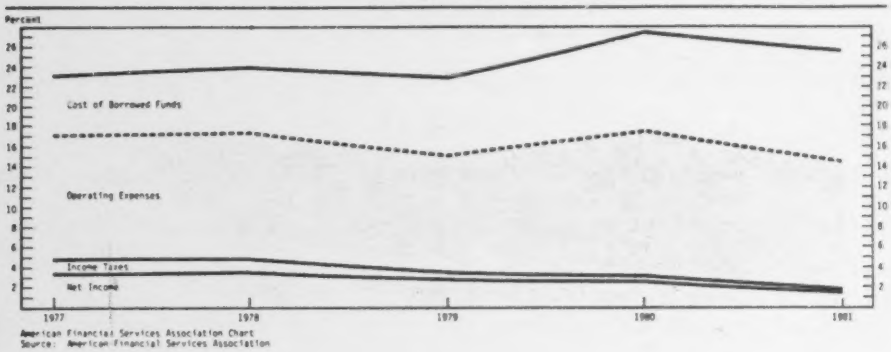
limits the options of grocers, competition among 2,000 large and small finance companies and over 40,000 depository institutions limits the charges asked by any lender.

The attached chart illustrates five-year experience for twenty-six large members of the American Financial Services Association that specialize in personal loans to consumers. In 1981 more than 77 percent of the receivables of these companies were in the form of personal loans to consumers, and together they held 57 percent of Federal Reserve Board estimates of the $33.3 billion total of finance company personal loans outstanding nationwide. Because of their importance in the industry, these companies provide an excellent sample to use in studying industry trends.

The top line in this chart illustrates the gross revenues of these 26 large companies in relation to their year-end domestic receivables. Interest on receivables, of course, accounts for a large portion of gross income of these companies, but not the entire amount. Gross revenues also include insurance commissions and dividends, net income from investment in nonconsolidated foreign subsidiaries, and other miscellaneous income sources. Thus, it is not proper to conclude that the top line represents the rate of charge on personal loans. While it contains interest from personal lending, it also contains other components.

The distance between the top line in the chart and the dotted line is these companies' costs of borrowed funds relative to domestic receivables. The widening space in the chart over the years clearly illustrates the escalating

Gross Income, Expenses, and Net Income of Personal Loan Companies
as a Percent of Receivables
1977-1981



American Financial Services Association Chart
Source: American Financial Services Association

Gross Income, Expenses, and Net Income of Personal Loan
Companies as a Percent of Domestic Receivables
1977-81

	1977	1978	1979	1980	1981
Gross Income	23.1	23.9	23.0	27.4	25.4
Cost of Borrowed Funds	6.0	6.6	7.8	9.8	11.0
Operating Expenses	12.4	12.4	11.4	14.2	12.7
Federal Income Taxes	1.4	1.4	0.8	0.7	0.3
Net Income	3.3	3.4	2.9	2.5	1.4
Net Income as a Percent of Equity	12.2	12.7	12.3	10.3	5.8

costs of borrowed funds 1977-81. Although these companies maintain substantial portions of their liabilities in long-term form, this does not immunize them to increases in market costs of funds. As may be seen in the chart and the table, borrowed funds costs rose rapidly from 6 percent of domestic receivables in 1977 to 11 percent in 1981. In order to continue paying their operating expenses and to earn a reasonable return on investment as funds costs rose, companies were forced to look for offsets during these years, including both higher charges and lower expenses where possible.

Subtracting costs of borrowed funds from gross revenues yields gross margins available for operating expenses including losses, taxes, and profits. This gross margin in relation to receivables may be seen as the shaded area in the chart. Rather than a rising margin over time, the chart shows a relatively steady margin before a substantial drop in 1981. In that year gross revenues in relation to receivables actually declined despite the runup in funds costs. Put another way, these companies were unable to cover any of their higher funds costs in 1981 through higher gross returns on receivables. The result was a substantial squeeze on gross margin and sharp pressure on profits.

The Recent Situation

Unfortunately, 1982 results have not yet been received from member companies and compilations will not be available for some months. Nevertheless, subject to revision as the

data become available, a few likely features seem predictable.

First, borrowed funds costs in relation to receivables may dip somewhat, although this is not at all certain. This result is unclear because long-term corporate bond rates in 1982 closely approximated 1981 rates even though the trend was downward. And, as old low cost long-term debt continues to run off, it still must be refunded at rates higher than in the 1950's and 1960's. Short term rates fell in 1982 compared to 1981, but they fell sharply only in the second half of the year, and the full-year average was very high by historical standards.

Second, it seems likely that firms probably attempted to maintain or raise charges whenever possible in 1982 in order to restore gross margins to historical levels. Of course, increasingly competitive personal loan markets may have forestalled this possibility for many companies. Combining the revenue and funds cost pictures, it seems likely that gross margins remained low by historical standards in 1982.

Third, it seems reasonable that the sharp cost cutting begun in 1981 continued in 1982. Faced by escalating funds costs, sharply higher losses due to personal bankruptcies, inflation in salaries, rent, utilities and social security taxes, and shrinking profit margins, personal loan firms speeded up the pace of change in their business in 1981. Secured second-mortgage loans at the 26 companies included in the chart reached 50.4 percent of personal loans in 1981,

up from only 14.4 percent in 1977 and 38.2 percent as recently as 1980. Even so, the 19 companies able to supply the information reported more than 40 percent of their losses in 1981 were due to bankruptcies. Reflecting the profit squeeze and the change in business, the 26 companies closed 16 percent of their offices nationwide in 1981. Furthermore, their number of employees declined 14 percent, reversing years of annual increases. After all these changes, net profit may have improved a little in 1982 compared to 1981.

Conclusion

In sum, available evidence on finance companies does not support the hypothesis that they are keeping rates high to widen margins compared to historical experience. Higher funds costs have forced finance companies to look for new revenues in recent years, but margins still have narrowed rather than widened. While it seems likely that firms in 1982 probably attempted to increase margins over the year before, 1981 margins were very narrow by historical standards, and it is not at all clear that firms would have been able to widen them very much. As a result, it seems probable that drastic cost cutting continued in 1982 along with maintenance of the longer-term trend toward a more profitable product mix.

AFSA thanks the Committee for the opportunity of expressing our views on the important issue discussed today.

Senator HAWKINS. Thank you. We'll go on and have Mr. O'Connor give his testimony now and then we'll ask questions.

Mr. O'CONNOR. Thank you, Madam Chairman. My name is Leonard O'Connor, I'm a vice president at the First National Bank of Boston and also the vice chairman of the Consumers Bankers Association.

I appreciate this opportunity to appear before the subcommittee to explain the components a financial institution considers in determining interest rates for consumer loans.

These rates are affected by external as well as internal circumstances. The state of the economy, the demand of the marketplace and the volatile environment of the financial services industry are external factors that influence the interest rates.

Each financial institution must then analyze its cost of funds, operating expenses, and credit losses in order to arrive at an interest rate that is not only competitive but also profitable.

The starting point in this analysis must be the state of the economy. Financial institutions do not operate in a vacuum. Rather, they operate in a world where volatile money rates and economic disruptions occur more often than in other industries. Banks are faced with pricing their products and services with no available mechanism to help them to determine what the economic situation will be like in the future.

FEDERAL DEFICIT CONTINUES

Today, as the Federal deficit continues to increase we cannot realistically assume that the cost of funds will remain at today's levels or decrease.

Retail-lending divisions are particularly affected by shifts in the economy because consumer loans are offered for terms as long as 15 years.

The financial services industry is undergoing a major evolution. Entities such as the money market mutual funds have successfully competed for deposits. All of the recent deregulation has centered on the liability side of the balance sheet of financial institutions.

While we welcome deregulation, as it has permitted us to compete for funds, it has also affected pricing policies.

As an example, we are still hampered by various State-imposed price controls. In my home State of Massachusetts, recent studies have provided evidence of the problems produced by imposed price control laws.

The Massachusetts Bankers Association and Peat, Marwick & Mitchell Co. conducted credit card studies of certain banks from 1979 through 1982. They reveal that the banks surveyed in 1979 lost $13.74 on each credit card account.

This escalated to $24.06 in 1981. In 1982 the loss was minimized because the cost of funds had decreased and banks were permitted to impose fees. Even so, banks still lost $2.13 on each account in 1982.

In Massachusetts, 32 percent of our customers never incur a finance charge. Therefore, they have a free use of the bank's funds for up to 45 days. The annual fee imposed by many banks is able to

reduce this cost; however, many States have prohibited or placed price controls on this fee.

Due to the value of products such as credit cards to their customers, many banks continue to offer these products and are developing pricing strategies to more accurately reflect the costs.

CALCULATE AN INTEREST RATE

To calculate an interest rate a bank must consider its cost of funds, operating expenses, and expected losses. Traditionally, banks have based their cost of funds on a combination of purchasing funds for loans and using funds deposited in the institution.

These costs have increased since mid-1978 when regulated depository institutions were first authorized to issue some market-sensitive certificates.

Recently, banks have been authorized to offer the Money Market Deposit Account and the Super NOW account with no ceilings on interest rates. Designed to stem the flow of money into nonregulated financial institutions, these accounts have been enormously successful.

Today most of the money deposited in banks receives a market rate of interest. As a result, the cost of funds has increased.

Inflation has affected not only the cost of money but also operational costs on banks. At First National Bank of Boston, operational costs amount to slightly more than 27 percent of the total expenses incurred in the installment loan function.

Another factor is the cost of compliance. Lenders must comply with the requirements mandated in a long series of consumer protection statutes that are well-known to this committee. These acts have resulted in further increased costs to the industry.

Another component in determining interest rate levels is the consideration of anticipated losses. Credit losses are not significantly affected by changes in interest rates. The extraordinary losses following the effective date of the 1978 Bankruptcy Reform Act and the continued high level of losses much be considered when a bank computes its finance charges. At First National Bank of Boston, bankruptcy loss is credit as a percentage of total losses have increased from 3.4 percent in 1978 to 12.9 percent in 1982. One west coast bank attributed 7.8 percent of its credit card losses in 1978 to bankruptcy, that figure increased to 25 percent in 1982. The tremendous losses due to bankruptcy contribute to the cost of credit.

The plight of the thrift associations over the last 5 years has provided a valuable lesson for all financial institutions. Many thrifts failed or had to merge, because a substantial portion of their loan portfolios was tied up in long-term, fixed rate loans. This situation has proven the necessity for balancing assets and liabilities within the bank and considering all the factors that comprise the cost of credit.

It would be extremely misleading to compare the prime rate to the interest rate charged on consumer loans. I will not attempt to define the components of the prime rate; however, it is basically the rate the banks may charge to selected corporations with excellent credit ratings. Further, these loans are usually either for very short term or are made at floating rate. Consumer loans, however,

are generally offered at the same rate for all customers for a longer period of time and at a fixed rate. As a result, the pricing considerations vary enormously, and it is inappropriate to compare the prime rate to the rate charged on consumer loans.

PRESSURES OF MARKETPLACE AFFECTS INTEREST RATES

Pressures of the marketplace also affect interest rates. At the present, the marketplace is highly competitive. Recently deregulation, such as the expansion of consumer lending powers to thrift institutions should produce even more competition. Additionally, consumers are well-informed. They shop around for a good return on their funds, as evidenced by the success of the money market funds and the new deposit accounts.

Similarly, to remain in business, banks must offer interest rates on loans that will attract customers. The price of credit is just as widely recognized and understood as other consumer commodities. In 1977, a Federal Reserve Board study shows consumer awareness of the cost of closed-end credit had increased to 54.5 percent of the population holding such credit and to an awareness factor of 71.3 percent among bank credit card holders.

We believe consumers do have a choice of interest rates. According to a survey conducted by the New York State Bankers Association in 1983, 20 commercial banks surveyed offered home improvement loans with interest rates ranging from 14.8 to 21.5 percent. Rates for new car loans varied between 13.5 percent and 21 percent.

I offer this information to counter the arguments that banks are fixing prices. Each bank must individually determine its pricing policy, then enter the market with as competitive a product as possible. The competitive nature of the marketplace also refutes the erroneous charge that banks are attempting to recoup losses from overseas loans by maintained high rates on consumer loans.

Any bank that tried to cover its foreign loan losses by charging higher rates on consumer loans would be priced out of the marketplace. At my bank the consumer loan portfolio is approximately six (6) percent of total loans, while the overseas portfolio is approximately 35 percent. It is impossible to suggest that a bank can offset overseas losses by raising consumer loan rates. Consumers would bank elsewhere.

SENATE BILL 730

We believe that S. 730, the Credit Deregulation and Availability Act of 1983, introduced by Senators Garn, Proxmire and Lugar, which would remove the remaining interest rate ceilings that apply to business, agricultural and consumer credit, would help the situation. It is essential that interest rates be determined by market forces and not by restrictive rate ceilings. Bank should be allowed to price their products based upon their costs, thereby permitting consumers to choose among the various products offered by banks.

Congress should also act to preempt State laws that restrict variable rate consumer loans. Historically, banks have structured the majority of their consumer loans on a fixed-rate basis. This method

was possible because of a relatively constant cost of funds generated from the banks' core deposits, low-inflation rates and a generally stable economic environment.

With these stable conditions present, banks could offer consumer loans at a fixed rate and insure acceptable profit margins throughout the term of the loans. This, however, is possible only as long as the costs of funds used to support the loans can be accurately predicted through the maturity of the loan.

If variable rates are permitted, the consumer stands to benefit from changes in the economy. In December 1982, a west coast bank offered fixed-rate home equity loans at an interest rate of approximately 14.75 percent, while the variable rate home equity loan carried a rate of 12.75 percent. If variable rates are permitted, the banks can charge rates that more accurately reflect the costs of the marketplace.

In conclusion, we can no longer depend on funds that have been traditionally available from checking accounts and passbook accounts. The unpredictable nature of the economy, the volatile nature of the marketplace, and the deregulation of the liability side of the ledger, the unprecedented increase in losses due to bankruptcies and the extensive regulations imposed upon the consumer banking industry, have all affected interest rates.

I hope that I have explained the internal processes that a bank undergoes when it prices its product, so that it is evident that the prime rate cannot be used as a measuring stick to determine interest rates on consumer loans.

Thank you for giving me the opportunity to testify today.

[Complete statement follows:]

TESTIMONY

OF

THE CONSUMER BANKERS ASSOCIATION

PRESENTED BY
LEONARD F. O'CONNOR

I am Leonard F. O'Connor, Vice President of the First National Bank of Boston. I am a member of the Executive Committee of The Consumer Bankers Association* and a former Chairman of its Government Relations Committee. I appreciate this opportunity to appear before this Subcommittee in order to explain the various components that affect a financial institution's consideration when interest rates for consumer loans are determined.

The interest rates on consumer loans are affected by external as well as internal circumstances. The state of the economy, the demands of the marketplace and the particular environment of the financial services industry are all factors that influence the interest rates not only for consumer loans but for a financial institution's entire loan portfolio. Internally, each financial institution must analyze its cost of funds, operating expenses and credit losses in order to arrive at an interest rate that is not only competitive but also profitable. As a highly regulated entity, a financial institution must be responsive to the public's financial needs. As a corporate entity, it is also responsible to its shareholders for maintaining and maximizing profits.

I would like to specifically address each of the factors that I have mentioned and also comment on the prime rate and its relation to the interest rate charged on consumer loans.

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*The Association is a nonprofit organization that was organized in October 1919 to provide a voice for the retail banking industry. Since that time, the membership of the Association has grown to over 500 commercial banks of all sizes that are actively engaged in extending consumer credit. Combined, the members of the Association now hold over 70 percent of all consumer credit outstandings held by commercial banks.

I. THE ECONOMY

The fundamental starting point in analyzing a financial institution's interest rate policies must be the state of the economy. Financial institutions do not operate in a void, but rather their policies reflect the disruptions in the economy more closely than most other industries. The volatile economic events of the past four years have caused financial institutions to re-evaluate their internal policies with respect to setting rates on all types of loans. During the previous twenty years interest rates remained fairly constant. This was a direct result of the fact that the economy was stable, the money supply was predictable, and Regulation Q assured an inexpensive source of funds. However, the recent inflationary spiral has changed the marketplace dramatically. Not only did the cost of money rise substantially, but also the traditional methods of predicting that cost were no longer viable. Financial institutions were faced with the problem of pricing their goods in an era of extraordinary inflation with no reliable mechanism available to help them determine what the economic situation would be like in the future. In fact, today, as the U.S. government deficit continues to increase, we cannot assume that interest rates or the cost of funds remain at today's levels or decrease in the near future. Consumer or retail lending divisions of banks are particularly affected by the dramatic shifts in the economy because consumer loans are generally offered at terms as short as one year to as long as fifteen years. As a result, retail lenders are forced to determine the interest rates they can charge based upon anticipated inflationary expectations.

II. THE ENVIRONMENT OF THE FINANCIAL SERVICES INDUSTRY

In addition to the general state of the economy, the financial services industry has been undergoing a major evolution. New entities such as the money

market mutual funds have successfully competed for savings that traditionally were placed with the regulated financial institutions at much lower mandated rates. Almost all of the recent deregulation has centered on the liability side of the balance sheet, which requires that financial institutions pay a market rate for consumers' funds. Certainly we have welcomed deregulation, as it has permitted us to compete in the marketplace for funds that we were rapidly losing or had lost. However, this has affected pricing policies, as deregulation on the asset side is still hampered by various finance charge restrictions or state-imposed price controls. Many states continue to prohibit or severely restrict fees and other charges for consumer credit (see Appendix A). These charges include: transaction fees; card membership fees; delinquency charges; points or fees charged to cover the costs of originating loans; third party closing costs; finder's fees; service charges; loan deferral charges; and charges for checks drawn on revolving credit accounts with insufficient balances. Such charges are necessary to cover increased operating and personnel costs associated with many consumer services such as originating and servicing loans. The high costs associated with managing an efficient and profitable retail lending operation must be covered by explicit fee pricing or by raising finance charges. However, state imposed price controls constrain the use of higher finance charges and sometimes require that fees and other charges be included in the calculation of total cost for booking a loan.

In my own state of Massachusetts, several recent studies have provided vivid evidence of the problems produced by imposed price control laws. In 1979 and 1980, the firm of Peat Marwick, Mitchell & Co. analyzed bank credit card operations. The Massachusetts Bankers Association conducted studies in 1981 and 1982.

The studies revealed that the banks surveyed in 1979 lost $13.74 on each credit card account. By 1980, that amount had increased to $19.67, and in 1981 to $24.06. In 1982, the loss was minimized because the cost of funds had decreased and banks were permitted to impose fees that helped to cover their expenses. Even so, banks still lost $2.13 on each account in 1982. On a per-transaction basis, each time a consumer used his or her bank credit card in 1979, the bank lost 81 cents. In 1980, the banks lost $1.23 on each credit card transaction. In 1981, the loss increased to $1.38. In 1982, the loss decreased to 11 cents a transaction, but again the loss was minimized because fees were permitted and the cost of funds had decreased during that year.

In the credit card area in Massachusetts, we have found that 32 percent of our customers never incur a finance charge. I understand that it has been reported to be as high as 55 percent for other credit card operations. Therefore, they have free use of the bank's funds for up to 45 days. The annual fee imposed by many banks has helped reduce this cost. Again, as you can see from Appendix A, many states have prohibited or placed price controls on this fee.

In order to determine an appropriate interest rate, banks must anticipate all relevant costs. Though such costs were sufficiently lower in 1982, banks still experienced a loss. In addition, the dramatic swings in the marketplace were beyond the banks' control, and remain so today. Though financial institutions cannot recapture those losses, they have learned that they must consider the unpredictable nature of the marketplace and the economy when they price their services.

Due to the value of products such as credit cards, to their customers, many banks have continued to offer these products (though many have withdrawn) and have developed pricing strategies that more accurately reflect the costs. Permitting fees has alleviated some of the difficulties. However, the cost of

funds and the overall focus of the marketplace are beyond the control of the banks, and still must be considered so that the services can continue to be offered.

III. INTERNAL FACTORS

In order to calculate an interest rate, a bank considers its cost of funds, operating expenses and certain expected losses.

Traditionally, banks have based their cost of funds on a combination of purchasing funds for loans and using existing funds deposited in the institution. These costs have increased since mid-1978, when regulated depository institutions were first authorized to issue 6-month Money Market Certificates (MMCs) and two-and-one-half-year (2½-year) Small Saver certificates at interest rates based on market rates for U.S. Treasury paper with comparable maturities.

Subsequently, banks were permitted to offer other accounts, such as the seven-to-thirty-one-day account and the ninety-day certificate, each of which offered a market rate of return. Most recently, banks have been authorized to offer the Money Market Deposit Account and the new Super NOW Account. There is no ceiling on the interest rates payable on these accounts. They were designed to stem the flow of money out of the banks into non-regulated financial institutions. The accounts have been enormously successful, and approximately $306.6 billion has been deposited in these accounts since December of 1982.

This phenomenon has had an enormous impact on interest rate pricing. Prior to 1978, banks had the use of money deposited by their customers on which they were limited by law to paying approximately 5 percent interest. Banks would then purchase whatever other money they needed to fund loans at market rates. The deposited money, however, kept the cost of funds down. Today, more and more of the money deposited in banks pays a market rate of interest. As a result,

the cost of funds has increased dramatically. In fact, traditionally many banks used consumer deposits to fully fund consumer loans.

When a bank prices its commodity -- in this instance, money -- it creates its strategy like any corporation would. It considers its basic cost of funds, and then it considers its operating expenses. Inflation has not only affected the cost of money, but also operational costs. Salaries have gone up considerably. Start-up costs, particularly in the credit card area account for a major portion of the cost of providing credit to consumers. At the First National Bank of Boston operating costs amount to slightly more than 27 percent of the total expenses incurred in the instalment loan function. Data from the Federal Reserve System's 1981 Functional Cost Analysis show that small banks incur higher operating expenses than do larger banks.

Additional information from the Federal Reserve System study shows that the average cost to make a loan in a small bank is $56.19. In a large bank (assets over $200M) this figure is $97.54. Also reported in the study is the fact that the average cost to collect a payment on a loan in a small bank is $4.66, while that cost is $5.17 for large banks.

Another operational cost is the maintenance of a bank's branch system. Banks provide branches for the convenience of their customers. For the past five years, due to the effects of inflation, costs for leases, utilities and personnel have increased dramatically. Experience has shown that banks must anticipate future increases in this area and include them as part of the costs of doing business. These costs are a result of the inflationary environment, and are not affected by the prime rate.

Another important factor is the cost of compliance. With the advent of Truth in Lending legislation in 1968, banks were required to comply with the disclosure provisions and other requirements of the Truth in Lending Act and

Regulation Z. Certainly, the disclosure of the costs of credit to consumers was beneficial, enabling consumers to understand the cost of credit more intelligently. However, it must be realized that in order to comply, banks incurred substantial operating costs. Further, the Truth in Lending Act was substantially revised in 1980, requiring lenders to revamp their disclosure forms. I am not here today to discuss the merits of Truth in Lending, but merely to apprise you of the various costs that banks incur as part of their overall operational expenses.

During the 1970s, lenders were deluged with a series of consumer protection statutes such as the Fair Credit Billing Act, Equal Credit Opportunity Act, Fair Credit Reporting Act, Electronic Funds Transfer Act, Home Mortgage Disclosure Act, Real Estate Settlement and Procedures Act, National Flood Insurance Act and the Community Reinvestment Act. Though Congress believed that consumers needed these various acts to provide necessary disclosures or protection, the acts have resulted in further increased costs to the industry. Each bank must have a compliance officer and significant legal backup personnel. Though these costs have been internalized, they are again a factor in pricing consumer credit products.

Another component in determining interest rate levels is the consideration of anticipated losses. Credit losses are not significantly affected by changes in interest rates. The extraordinary losses during 1980 and 1981, following the effective date of the 1978 Bankruptcy Reform Act, and the expectation of a continued high level of losses must be considered when a bank computes its finance charges. At First National Bank of Boston, bankruptcy losses, as a percent of total losses, in 1979 were 6.4 percent, in 1980, 12.4 percent, in 1981, 11.8 percent, and in 1982, 12.9 percent compared to those in 1978 of 3.4 percent. Prior to the effective date of the 1978 Bankruptcy Reform Act, a West Coast bank attributed 7.8 percent of its total loan losses to bankruptcy, while

in 1982 the bankruptcy losses increased to 25 percent. Although a major New York bank has tightened its credit granting policies, its losses due to bankruptcy have continued to increase and during 1982 ranged from 25 to 30 percent of total credit losses. Credit card losses due to fraud are also incurred and must be anticipated. Interest rates cannot be viewed in a vacuum. The tremendous losses due to bankruptcy also contribute to the cost of credit. The Consumer Bankers Association has vigorously supported consumer amendments to the Bankruptcy Code, as evidenced in S. 445. This legislation would inhibit the new practice of using bankruptcy as a financial planning tool. The Bankruptcy Reform Act, in some respects, has encouraged people who could afford to repay their debts to declare bankruptcy instead. The banks have been faced with the problem of extending credit to applicants who appear to be creditworthy only to find out later that too many of them have taken advantage of the Bankruptcy Code to avoid their debts. As long as these conditions exist, banks must anticipate and include a factor for such losses when they compute the interest rate on a loan.

Based on my experience at the First National Bank of Boston, I have attempted to explain the components that we consider in determining the interest rate charged on loans. The costs involved do vary depending on the type of loan that is granted. Any long-term, fixed-rate extension of credit must include all of the internal and external factors affecting the marketplace. The plight of the thrift associations over the last five years has provided a valuable lesson for all financial institutions. Too many thrifts failed or had to merge because a substantial portion of their loan portfolio was tied up in thirty-year mortgage loans where a fixed rate had been set at a time when the economy was stable and the cost of funds was low. These long-term loans were also based on the expectation that the economy would not change as dramatically as it has during the past few years and that Regulation Q would assure a constant flow of below-market-rate

funds with a competitive advantage to thrifts via the differential. The last five years have proven the necessity for balancing assets and liabilities within the bank and, most importantly, considering all of the factors that comprise the cost of credit. Only by considering all of these components can banks continue to offer the credit services that consumers request.

III. PRIME RATE - CAN IT BE DEFINED?

I would also like to convey my understanding of why it can be misleading to compare the prime rate to the interest rate charged on consumer loans. Experts disagree on the definition and function of the prime rate, and I will not attempt to define its components. Basically, however, the prime rate is a rate that banks may charge on loans to large corporations with AAA bond ratings. Further, these loans are usually short-term -- offered for a period of approximately thirty days or with a floating rate that reflects changes in the marketplace. Consumer loans, however, are generally offered for a considerably longer period of time -- i.e., up to fifteen years for a home improvement loan 48 to 60 months for an automobile loan. In addition, consumer loans are generally extended at a fixed rate for the term of the loan. As a result, the pricing considerations vary enormously, and it is extremely difficult, if not impossible, to really compare the prime rate to the interest rate charged on consumer loans.

IV. MARKETPLACE COMPETITION PREVENTS ARTIFICIALLY HIGH INTEREST RATES

In addition to the pricing factors I have discussed I would like to comment on how the pressures of the marketplace affect interest rates. Once a bank has determined its costs it must then look to the marketplace to ensure that its product can effectively compete in the market. At present, the credit marketplace is highly competitive. Recent industry deregulation developments such as the

expansion of consumer lending powers of savings and loan associations and mutual savings banks will only produce more competition. Examples of the effects of competition abound. In California, where banks are not subject to imposed rate ceilings, there is a dearth of evidence of harassment, either by excessive rates or other means. In fact, California is considered by many to have the most progressive retail banking industry in the United States. Moving in the same direction, Arizona, New Jersey, New York, New Mexico, Montana, Delaware, North Dakota, South Dakota and Virginia have recently abolished civil usury penalties -- presumably because their legislatures believed competition is sufficient to regulate rates.

The Federal Reserve Board has studied a number of credit-granting firms and the degree of concentration in 213 standard metropolitan statistical areas and 233 county markets between 1966 and 1975. The conclusion reached by the Board was that more markets experienced structural changes that enhanced competition than changes that reduced it. In support of this view, a 1980 study on usury by the U.S. Treasury Department's "Interagency Task Force on Thrift Institutions" argues that ceilings actually hinder competition. The study contends that usury ceilings act as a positive disincentive for thrifts to diversify into consumer lending, and therefore act as a barrier to competition.

The current development of a well-populated, diverse, widely advertised and highly competitive market -- composed of banks, finance companies, retailers and now new, short-term lending programs undertaken by credit unions, savings and loan associations and mutual savings banks -- will cause a significant increase to the supply side of the lending equation.

Today, consumers are intelligent and informed. They "shop around" for a good return on their investments, as evidenced by the success of the money market funds and the new deposit instruments offered as a result of the recent

Garn - St Germain legislation. In the same vein, in order to remain in business, banks must offer interest rates on loans that will attract consumers who are aware of rates.

It is indeed important that consumers be aware of a product's price in order for the market to function. The price of credit is just as widely recognized and understood as many other consumer commodities. Literally millions of dollars have been expended by various financial institutions to educate consumers as to the cost of borrowing through the Truth in Lending Act. A 1977 Federal Reserve Board study shows consumer awareness of the cost of closed-end credit has increased to 54.5 percent of the population holding such credit and to an awareness factor of 71.3 percent among bank credit card holders. The same study showed that in 1969 consumer awareness of closed-end credit annual percentage rates was 14.5 percent and, for bank card holders, 26.6 percent. A 1978 study of California bank card holders found that almost 80 percent of the sample knew the annual percentage rate. Undeniably, such a dramatic increase in consumer awareness is more than adequate to assure rate competition among credit grantors and should alleviate any concern that borrowers might be taken advantage of by lenders.

The late Senator Paul Douglas, a noted economist and the "father" of the Truth in Lending Act, once stated that a mere 10 percent awareness factor would cause a significant market reaction. The National Commission on Consumer Finance determined that if one-third to one-half of the individuals in the general market were aware of credit costs, creditors would be forced to operate in the market in a highly competitive manner.

Consumers do have a choice of interest rates, according to a survey conducted by the New York State Bankers Association on the interest rates charged on certain loans by twenty (20) commercial banks in that state. The banks surveyed

hold loan portfolios that encompass a substantial proportion of the consumer loans outstanding in New York state. The survey was conducted in February 1981, November 1982 and January 1983 (see Appendix B). Although the average interest rate has not changed dramatically, the interest rate range should be noted. In January 1983 the banks surveyed offered home improvement loans with interest rates ranging from 14.8 percent to 21.5 percent. Rates for new car loans varied between 13.5 percent and 21 percent, while interest rates on used car loans ranged from 14.8 percent to 24.5 percent. As the operation of credit card services is more complex than other types of loans, the annual percentage rates ranging from 18 percent to 19.9 percent demonstrated, as expected, less variation. I offer this information to counter the arguments that banks are "fixing prices." Each bank must individually determine its pricing policy, placing the safety and soundness of the institution at the forefront of its considerations, and then enter the market with as competitive a product as possible.

The competitive nature of the marketplace also refutes the erroneous charge that banks are attempting to recoup losses from overseas loans by maintaining high interest rates on consumer loans. In California over two hundred (200) institutions offer consumer loans, a majority of which do not have loans outstanding to foreign countries. Any bank that tried to recoup its foreign loan losses by charging higher rates on consumer loans would be priced out of the marketplace immediately. At my bank, the consumer loan portfolio is approximately six percent (6%) of total loans, while the overseas loan portfolio is approximately 35 percent. It is impossible from a legal standpoint, given state price restraints, as well as from a competitive standpoint, given the demands of the marketplace, to suggest that a bank could offset losses on overseas loans by raising consumer loan rates. Consumers would bank elsewhere.

V. SUGGESTED SOLUTIONS

I have already discussed the impact of the 1978 Bankruptcy Reform Act and the legislation that would address the problems in that area. I would like to also mention S. 730, a bill that would amend the Depository Institutions Deregulation and Monetary Control Act of 1980, entitled Credit Deregulation and Availability Act of 1983. Introduced by Sens. Garn (R-UT), Proxmire (D-WI) and Lugar (R-IN), this bill would complete the deregulation process begun three years ago with the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980. That law resulted in the elimination of all credit rate ceilings applicable to mortgage credit in order that funds would be available to consumers wishing to purchase a home. This act follows the mortgage credit precedent by removing remaining interest rate ceilings that apply to business, agricultural and consumer credit. In his introduction of the bill, Senator Garn stated:

> ...consumers are demanding and receiving a fair rate of return on money deposited in these new types of accounts. However, it is obvious that financial institutions will not be able to continue to pay market rates on these deposit accounts, if they are not permitted to charge market rates for credit.*

As you can see by Appendix A, the interest rates on consumer loans vary among states as well as on the type of loan. Imposed rate ceilings have resulted

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* 129 Congressional Record, S. 2332, March 8, 1983.

in a serious reduction in credit availability during periods of inflation. It is essential that interest rates be determined by market forces, and not governed by arbitrary and artificial, restrictive rate ceilings. Banks should be allowed to price their products based upon their costs, thereby permitting consumers to intelligently choose among the various products offered by the banks.

Congress should also act to preempt those state laws that restrict variable rates on consumer loans. Banks have historically structured the majority of their consumer loans on a fixed-rate basis. This method was made possible because of a relatively constant cost of funds generated from banks' core deposits, low inflation rates and a generally stable economic environment.

With these stable conditions present, banks could offer consumer loans at a fixed rate and ensure acceptable profit margins throughout the term of the loans. This, however, is only possible as long as the cost of funds used to support fixed-rate loans can be accurately predicted through the maturity of the loan.

Inflation has become a fact of life, and double digit inflation seemed to be a reality during the early part of this decade. Bankers are feeling the effects of inflation and rapidly changing market conditions in the costs of their core deposits. Regulatory changes such as the phasing out of Regulation Q, the advent of money market certificates and the evolution of NOW accounts have caused major shifts in the mix of core deposits at banks. As a result of these shifts, traditional core deposits are "evaporating," and will continue to shift into more expensive and volatile sources of funds.

Though depositors seek relief through higher-yielding, short-term instruments, borrowers are requesting longer terms on consumer loans to purchase goods and services. Banks are finding it increasingly more difficult to anticipate the cost of funds used to support new fixed-rate consumer loans through loan maturity.

Since current fixed rate contracts cannot be adjusted to match higher costs of funds, many banks are now experiencing a diminished or negative profit margin on their consumer loan portfolios.

There are many challenges that banks must face during the 1980s with regard to consumer loans. The most important of these is to be able to match loan yields with the cost of funds over the terms of the loans to ensure an acceptable profit margin. Offering variable-rate consumer credit, defined simply as that strategy which uses a rate to compute the finance charge that does not remain constant during the term of the loan is one solution to the problem.

If variable rates are permitted the consumer stands to benefit from changes in the economy. In December 1982 a West Coast bank was charging thirteen (13) percent on adjustable-rate loans for mobile homes. A fixed-rate home equity loan had an interest rate of approximately 14.75 percent, while a variable-rate home equity loan carried a rate of 12.75 percent. If variable rates are permitted, the banks can charge rates that more accurately reflect the costs of the marketplace.

An East Coast bank compared the consumer interest rates (APR) for revolving credit that showed the different interest rates charged under fixed rates during 1981 and variable rates during 1982 (see Appendix C). The interest rates under both fixed- and variable-rate programs were approximately the same (18 percent) during the first quarter of each year. However, the rates varied considerably in a comparison of the fourth quarter, where the interest charged on a fixed-rate loan was nearly 21 percent and the interest charged on the variable loan was approximately 14.7 percent. The bank predicts that in 1983 the rates will be less than 14 percent for variable rate loans. In today's rate environment, variable-rate borrowers would have enjoyed lower-priced products and lenders could have achieved a better return on their investment in consumer loans.

CONCLUSION

In conclusion, banks can no longer depend on funds that have been traditionally available from non-interest bearing checking accounts and low interest bearing passbook accounts. The unpredictable nature of the economy, the volatile nature of the marketplace, the deregulation of the liability side of the ledger, the unprecedented increase in losses due to consumer bankruptcies and the extensive regulations imposed upon the consumer banking industry have all affected interest rates. I hope that I have explained the internal processes that a bank undergoes when it prices its products so that it is evident why the prime rate cannot be the measuring stick used to determine interest rates on consumer loans.

Thank you for giving me the opportunity to testify today.

APPENDIX A

STATE	INSTALLMENT LOAN	REVOLVING LOAN	BANK CREDIT CARD	ANNUAL CARD FEE	SECOND MORTGAGES	MOTOR VEHICLES	INDUSTRIAL BANK
ALABAMA	Small Loans: 3%/$200/2%/$749 Installment Loans And Credit: add-on 15%/$750/10%/$200/8% or alternative rate of 18% actuarial. No limit over $5,000.	21%/$750/18%	21%/$750/18%	$15	18% deregulated over $5M	15%/$750 10%/$2,000. 8%/$5,000./ no limit	no statutory provisions
ALASKA	6% per year discount	18%/$1,000./12%	18%	$15	5% over discount rate charged by 12th Fed Reserve district, no limit over $25,000	no limit	no statutory provisions
ARIZONA	no limit	no limit	no limit	yes, no limit	no limit	rate set by contract	10% discount; $1,000 limit, 12 months
ARKANSAS	17%	17%	17%	yes, no limit	17%	17%	17%

STATE	INSTALLMENT LOAN	REVOLVING LOAN	BANK CREDIT CARD	ANNUAL CARD FEE	SECOND MORTGAGES	MOTOR VEHICLES	INDUSTRIAL BANK
CALIFORNIA	30%/$225/24%/ $900/18%/$1,650./ 12%/$10,000., but not less than 19.2%	18%/$1,000./ 12%	no limit	$15	no limit for regulated lenders	add-on; 12%; but simple interest graduated scale up to 24%	24%/$1,000./ $10,000., but not less than 19.2%
COLORADO	25%/$630/20%/ $2,100./15%/ $25,000.	21%	21%	yes, no limit specified	21%	21%	21%
CONNECTICUT	21%	18%	18%; 15% after 10-1-83	yes, no limit specified	no limit	actuarial; 6% discount Classes: 1-18% 2-19¼% 3-21¼%	
DELAWARE	no limit	no limit	no limit	yes, in addition to or in lieu of interest	no limit	rate set by contract	no statutory provisions
DISTRICT OF COLUMBIA	21%	18%	18%	no provision	15%	actuarial; Classes: 1-21¼% 2-23¼% 3-27% 4-28.33%	no statutory proviaions

TATE	INSTALLMENT LOAN	REVOLVING LOAN	BANK CREDIT CARD	ANNUAL CARD FEE	SECOND MORTGAGES	MOTOR VEHICLES	INDUSTRIAL BANK
LORIDA	18%	18%	18%	no provision, but allowable by Attorney General opinion 5-16-80, plus unofficial opinion 5-22-82	18%	add-on; Classes: 1-10% 2-11% 3-15% 4-17%	18%
EORGIA	7% add-on	21%	18%	$12	9% add-on	add-on; Classes: 1-10% 2-13% 3-15% 4-17%	10%
AWAII	same as Industrial Bank	24%	18%	$12	12%	24%	24% (under 15 years), or 14%/18 months 10½%/12 months 7%/12 months 4%/6 months until 7-1-85
DAHO	21% or 36%/ $840/24%/ $2,800/18%/ $70,000.	21%	21%	yes, no limit specified	21%	21% or 36%/$840/ 24%/$2,800./ $15%/$70,000.	no statutory provisions
LLINOIS	no limit	no limit	no limit	$20	no limit	no limit	no statutory provisions

STATE	INSTALLMENT LOAN	REVOLVING LOAN	BANK CREDIT CARD	ANNUAL CARD FEE	SECOND MORTGAGES	MOTOR VEHICLES	INDUSTRIAL BANK
INDIANA	21% or 36%/$540/ 21%/$1,800./15%/ $45,000.	18%	21%	yes, no limit specified	21% (supervised loans) 18%/other consumer loans	36%/$660/ 21%/ $2,200./ 15%	21% or 36%/$600/ 21%/ $1,540./15%/ $55,000./ no limit
IOWA	21% up to $35,000.	18%/$500/15%	18%/$500/15%	yes, no limit specified	21%	Classes: 1-21% 2-14% 3-27%	10% add-on or discount
KANSAS	21% or 36%/$540/21%/ 1,800./14.45%	same as installment loan	same as installment loan	yes, no limit	same as installment loan	same as install-ment loan	no statutory provisions
KENTUCKY	8% discount	18%	18%	not permitted	lesser of 19% or 4% over the Fed discount rate; no limit over $15,000.	add-on; Classes; 1-11% 2-13% 3-15%	8% add-on or discount per year
LOUISIANA	35%/$1,400./ 27%/$4,000./24% $7,000./21%	21%	18%	$12	12%	Classes: 1-18% 2-24% 3-30% 4-33%	no statutory provisions

STATE	INSTALLMENT LOAN	REVOLVING LOAN	BANK CREDIT CARD	ANNUAL CARD FEE	SECOND MORTGAGES	MOTOR VEHICLES	INDUSTRIAL BANK
MAINE	30%/$300/21%/ $1,000./15%; or 18%, whichever is greater	30%/$300/21%/ $1,000./15%; or 18%, whichever is greater	18%	yes, no limit specified	18%	actuarial; Classes: 1-18% 2-20% 3-23½%	rate to be set by Superintendent. Maximum loan 4% of capital and surplus on direct obligations of any one person, and 15% on indirect obligations
MARYLAND	33%/$1,000./24% $2,000./24%	24%	24%	not permitted	24% actuarial; Rule of 78s permitted	24%; except; 27% for autos more than 2 years old	no statutory provisions
MASSACHUSETTS	23% up to $6,000.; no limit over $6,000.	18%	18%	yes, no limit specified	18%	add-on 12%	12% discount up to $500 otherwise 9%
MICHIGAN	12.83%, or most favored lender doctrine	20.4%	18%	yes, no limit specified	15%	16½% actuarial	no statutory provisions

STATE	INSTALLMENT LOAN	REVOLVING LOAN	BANK CREDIT CARD	ANNUAL CARD FEE	SECOND MORTGAGES	MOTOR VEHICLES	INDUSTRIAL BANK
MINNESOTA	higher of 12% actuarial or 4½ over Fed discount rate	18% if no annual fee; 12% with annual fee	18% if no annual fee; 12% with annual fee	$15	no limit	add-on; Classes: 1-10% 2-11% 3-13%	33%/$350/19%/ $35,000, but not less than 21 3/4%
MISSISSIPPI	6% add-on	24%/$2,500./21%	21% through 6-30-84; then 18%/ $800/15%/ $1,200./12%	no provision, although S.B. 2626, enacted 4-20-82, did not address the issue		actuarial; Classes: 1-14% or 5% above Fed discount rate 2-21% 3-26 3/4% 4-28 3/4%	no statutory provisions
MISSOURI	26.6%/$800/ 15%/$2,500./10%	26.6%/$800/15%/ $2,500./10%	22%/$1,000./ 10%	not permitted	20% (1.67%/ month)	add-on; Classes: 1-10% 2-10% 3-13%	no specifics; may be governed by existing usury laws
MONTANA	no limit until 7-1-83, then 4% above Fed discount rate	no limit until 7-1-83	no limit until 7-1-83	yes, no limit specified	no limit	no limit	no statutory provisions

STATE	INSTALLMENT LOAN	REVOLVING LOAN	BANK CREDIT CARD	ANNUAL CARD FEE	SECOND MORTGAGES	MOTOR VEHICLES	INDUSTRIAL BANK
NEBRASKA	19% actuarial	21%/$500/18%	18%	$20	no limit, if loan is guaranteed, sponsored, or participated in by any agency, department, or program of U.S. or state government	18%	19% actuarial
NEVADA	no limit	no limit	no limit	yes, no limit	no limit	no limit	no limit for loans of $3,500. to $5,000.
NEW HAMPSHIRE	no limit	no limit	no limit	no provision and silent on interpretation	no limit	no limit	no statutory provisions
NEW JERSEY	no limit	no limit	no limit	$15	no limit	no limit	no statutory provisions
NEW MEXICO	no limit (rate deregulation in all categories expires 7-1-83)	no limit	no limit until 7-1-83; then 18%/$500/16%	yes, no limit specified	no limit	no limit	no statutory provisions

STATE	INSTALLMENT LOAN	REVOLVING LOAN	BANK CREDIT CARD	ANNUAL CARD FEE	SECOND MORTGAGES	MOTOR VEHICLES	INDUSTRIAL BANK
NEW YORK	no limit until 7-1-83 criminal usury ceiling: 25%	no limit	no limit	yes, no limit	no rate limit; amount must exceed $4,000.	no limit	no statutory provisions
NORTH CAROLINA	15% actuarial (unsecured) to $5,000.; 16% or 6% above 6-month T-bills; up to $25,000.; no limit above $25,000.	18%	18%	yes, "reasonable annual charge for membership" (4th Circuit Court judgment)	greater of 16% simple interest or 5% over Fed Reserve discount rate	actuarial; Classes: 1-18% 2-20% 3-22% 4-29%	same as installment loan
NORTH DAKOTA	no limit	18%	18%	no provision	no limit for banks	no limit for banks	no statutory provisions
OHIO	no limit	25% until 1-1-85	25% until 1-1-85	no provision	28%/ $1,000./ 22%/ $5,000./ 3% above Fed discount rate	25% until 1-1-85	no statutory provisions

STATE	INSTALLMENT LOAN	REVOLVING LOAN	BANK CREDIT CARD	ANNUAL CARD FEE	SECOND MORTGAGES	MOTOR VEHICLES	INDUSTRIAL BANK
OKLAHOMA	21% or 30%/$600/ 21%/$1,800./15% $45,000.	same as installment loan	24%	yes, no limit specified	no limit	same as revolving and installment loan	no statutory provisions
OREGON	no limit	no limit	no limit	yes, no limit	no limit	no limit	no statutory provisions
PENNSYLVANIA	6% discount	revolving loan credit - 24%; revolving charge credit - 15%; bank revolving loan (check loan) - 12%	18%	$15	17.4%	add-on; Classes: 1-8% 2-9% 3-12% 4-7½%	no statutory provisions
RHODE ISLAND	21% or 9% over current 6-month T-bill rate	21%	21%	no provision but allowable by 1981 Superior Court decision (Industrial Bank of R. I. vs. Attorney General)	21%; expires 6-1-83, then reverts to 15%	same as installment loan	no statutory provisions

STATE	INSTALLMENT LOAN	REVOLVING LOAN	BANK CREDIT CARD	ANNUAL CARD FEE	SECOND MORTGAGES	MOTOR VEHICLES	INDUSTRIAL BANK
SOUTH CAROLINA	supervised loans: 18% or 36%/$650/ 21%/$1,500./15% bank and other installment loans: add-on 7%	revolving charge: 24%/$650/18% revolving loan: 18% bank revolving loan: 18%	18%	yes, no limit specified	18%	add-on; Classes: 1-7% 2-8% 3-10% 4-15% 5-16%	no statutory provisions
SOUTH DAKOTA	add-on 8%/$1,000./7% $20,000.	revolving charge: 1 2/3% per month, expires 7-1-83	no limit	yes, no limit specified	no limit	Classes: 1-20% 2-23% 3-27%	no statutory provisions
TENNESSEE	sliding scale: 10.53%-less than six months 11.58%-6-12 months 12.59%-12-24 months 13.38%-24-36 months 14.17%-36-48 months 15.04%-48-60 months 16.20%-60-72 months 17.18%-72-84 months 18.00%-over 84 months	21%	21%	no provision	5% above Fed Reserve discount rate; not to exceed 18%	no limit	7½% discount with maximum effective rate of 18%

STATE	INSTALLMENT LOAN	REVOLVING LOAN	BANK CREDIT CARD	ANNUAL CARD FEE	SECOND MORTGAGES	MOTOR VEHICLES	INDUSTRIAL BANK
TEXAS	fluctuating rate twice the 6-month T-bill rate, but must remain between 18% and 24%	fluctuating rate between 18% and 24%, tied to 6-month T-bill rates (currently 22.72%)	same as revolving loan	not permitted	add-on 8%	add-on; Classes; 1-7.5% 2-10% 3-12.5% 4-15% (if Class 4 under $300, then 18% add-on)	no statutory provisions
UTAH	21% or 36%/$840/21%/ $2,800./15% $55,000.	same as installment loan	same as installment loan	yes, no limit specified	same as install-ment loan	same as install-loan	same as installment loan
VERMONT	24%/$1,000./12% but less than 18%	18%/$500/15%	18%/$500/15%	$15	18%	18% for current and previous model year; 20% for older models	no statutory provisions

STATE	INSTALLMENT LOAN	REVOLVING LOAN	BANK CREDIT CARD	ANNUAL CARD FEE	SECOND MORTGAGES	MOTOR VEHICLES	INDUSTRIAL BANK
VIRGINIA	no limit	18%; bank check credit 12%	18% until 4-1-83; then no limit	$15	18% actuarial plus flat 2% fee on loan	loans under 10 years, 2 months, 9% add-on if charged in advance or 18% simple if not charged in advance. No limit on loans over 10 years, 2 months	no industrial banks, but no limit on industrial loan associations
WASHINGTON	no limit	18%	4% over 6-month T-bill rate	$25	4% over equivalent coupon issue yield of average T-bill rate for 26-week T-bills determined during preceding calendar month	no limit	18% discount per year plus 2% flat fee and 50¢ per month service charge
WEST VIRGINIA	bank and other installment loans: 6% or discount installment sales, other goods: 18%/ $1,500./12% $25,000.	18%	18%	yes, no limit specified	6% add-on fees not to exceed 18% of loan	actuarial; Classes: 1-12% 2-16% 3-18%	6% discount plus $1 per $50 or fraction

STATE	INSTALLMENT LOAN	REVOLVING LOAN	BANK CREDIT CARD	ANNUAL CARD FEE	SECOND MORTGAGES	MOTOR VEHICLES	INDUSTRIAL BANK
WISCONSIN	18% or 6% plus the T-bill rate rounded up to nearest ½% on loans under $25,000. No limit over $25,000., until 10-1-84	18% unless constant yield on 2-year Treasury securities exceeds 15% for 5 successive Thursdays, in which case no limit for next six months	18%	yes, no limit specified	no limit	same as installment loan	no statutory provisions
WYOMING	36%/$300/21%/ $1,000./15%/ $25,000.; but rate need not be less than 21%	21%	21%	yes, no limit specified	21%	same as installment loan	no statutory provisions

APPENDIX B

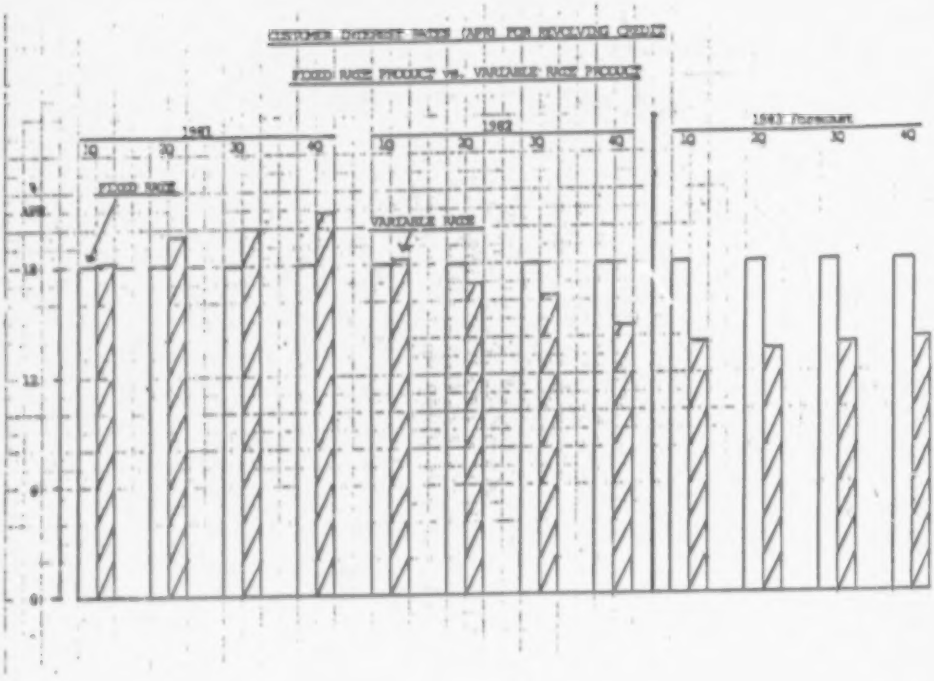
NEW YORK STATE BANKERS ASSOCIATION

	FEBRUARY 1981	NOVEMBER 1982	JANUARY 1983
Home Improvement Loans			
average*	18.2	18	17.6
range**	16.3 - 20	14.4 - 21	14.8 - 21.5
New Car Loans			
average*	17.4	17	16.6
range**	15 - 19.6	13.4 - 21	13.5 - 21
Used Car Loans			
average*	18	18.6	17.9
range**	15.5 - 19.6	14.4 - 21	14.8 - 24.5
Credit Cards			
average*	16.8	19.3	19.2
range**	12 - 19.8	18 - 21	18 - 19.9
Cash Advances			
average*	16.3	19.3	19.1
range**	12 - 19.8	18 - 21	18 - 19.9
Overdraft Checking			
average*	16	18.6	18.4
range**	12 - 18	17.5 - 19.8	13.5 - 20

* average of rates offered in percents

** range of rates offered in percents

APPENDIX C


1981
1982
1983 (forecast)
1Q
2Q
3Q
4Q
FIXED RATE
VARIABLE RATE
APR
12
8
0

Senator HAWKINS. Thank you, Mr. O'Connor.

Mr. Durkin, were you here for Mr. Schechter's testimony this morning?

Mr. DURKIN. Yes, I was.

SUBSIDIZED INTEREST RATE PROGRAM

Senator HAWKINS. The 11.9 percent financing on automobiles has caught everybody's eye. He stated that the auto companies are not subsidizing those rates. There is an article in the the "New York Times," however, that appears to indicate that these rates are applied to the special subsidized interest program being offered to all creditors.

Could you please tell me what you know about this?

Mr. DURKIN. Well, I, of course, know a little bit about it. Although I haven't spoken to anyone in one of the automobile finance companies about that, it is certainly my impression that those are subsidized rates. I know they've had some problems in some States with the dealers participating in buying down the rate from the finance company, and whether that's legal under the laws of the States, and so forth. So it certainly appears to me that the information in the "New York Times" was correct rather than the statement made by Mr. Schechter. Furthermore, General Motors, the parent factory corporation, stands behind the finance subsidiary, and if the subsidiary were to generate losses on this type of credit, it wouldn't be the same as an independent company generating losses. The factory has always capitalized that company and designed its agreements with the lenders to maintain the capital of that company such that the lenders to that company are well protected.

Senator HAWKINS. So the private finance companies cannot compete with GMAC?

Mr. DURKIN. The answer to that question is, yes, they cannot compete with GMAC, at least historically.

Senator HAWKINS. Excuse me. Can any of your members?

Mr. DURKIN. Well, GMAC is one of our members, as are other finance companies, but historically, automobile credit was made available by a variety of finance companies. Not only because of the competition of GMAC, but also because of the banks and credit unions and increasing competition in automobile credit generally, they have tended to withdraw from this market. Today the only finance companies that are actively financing new automobiles are the subsidiaries of the factories.

Those are General Motors Acceptance Corp., Ford Motor Credit and Chrysler Credit Corp.

Senator HAWKINS. Are you familiar with the article that I am citing?

Mr. DURKIN. The article which you're citing? I do see articles from the "New York Times."

GMAC BORROWS LONG-TERM FUNDS

Senator HAWKINS. General Motors Acceptance regularly borrows long-term funds to finance its medium-term auto loans. As of Feb-

ruary, GMAC went to banks in Europe to borrow $200 million for 7 years. The rate was 10.5 percent.

Mr. DURKIN. Yes. Well, General Motors Acceptance Corp. is not only the largest finance company in the world, it's one of the largest financial institutions in the world, and it looks for funds from virtually every source it can find them. That would also include banks and insurance companies.

Senator HAWKINS. What about the Ford Motor Credit Co.?

Mr. DURKIN. The same with Ford. It's not as large as General Motors, but it would look for funds from a variety of sources, including the Eurodollar markets.

Senator HAWKINS. How about Chrysler Credit Corp.?

Mr. DURKIN. Chrysler Credit Corp. has, of course, in recent years had a much more difficult time, because of the problems of the parent. Historically, it has borrowed from Wall Street and from insurance companies and other sources. These would still be included among its lenders, but it would be a much riskier credit.

Senator HAWKINS. But they've also been offering 11.9 percent.

Mr. DURKIN. Those presumably involve the same kinds of buy downs from the factory to move the automobiles, as well as the dealers participating.

Senator HAWKINS. In your opinion, large banks cannot compete in this kind of borrowing?

Mr. DURKIN. Well, large banks also borrow in the Eurodollar markets as do commercial firms not involved in financing of consumers. So there is a variety of borrowers in Eurodollar markets. You did mention, I believe, the 10.5 percent rate that General Motors borrowed in the Eurodollar market. That, of course, is not a very large spread, when you have to consider the risk of that portfolio, the operating costs of generating that type of credit. That would, in fact, be quite a small spread, very narrow.

Senator HAWKINS. The article said that spread may not be enough to entice an arm's length lender, like a bank.

Mr. DURKIN. I think that's probably right although I haven't said very much about the operations of banks.

Senator HAWKINS. But it does raise the question, gentlemen, of whether bank auto loan rates of 17.9 are justified.

Mr. DURKIN. One advantage that General Motors Acceptance Corp. has, of course, is that it is supported by the factory, whereas the banks are not supported by the factory. And the factory would be less inclined to bring down the banking rates. On the other hand they do some of that. My understanding is that Chrysler Corp. has that kind of arrangement with certain banks.

Senator HAWKINS. We need to hurry along. And I need to ask you a couple of questions, and I'll submit the rest of them in writing, so if we could have it for the record, please.

GOOD MANAGEMENT COSTS CONSUMERS OR STOCKHOLDERS LESS

Senator HAWKINS. I'll ask both of you. Mr. O'Connor, does good management cost consumers less or stockholders less?

Mr. O'CONNOR. I think I'd have to restate the question. I'm not sure I understand it. Good management?

Senator HAWKINS. Good judgment, good management, in making better loans. Does that cost consumers less? You told me how much it cost consumers to make bad loans.

Mr. O'CONNOR. I would definitely say that good management would certainly tend to benefit everyone, consumers, stockholders, employees, that never seems to hurt. I guess to expand on that, in terms of operating costs, certainly good management can be a big factor in reducing those operating costs, and certainly good management impacts on the quality of the credit that's being purchased. Again, I think everyone benefits from that, including the consumers. As I said in my testimony, each bank has to consider its internal costs, and one of those are operating costs that can be directly impacted by good management and, in fact, funding costs can be impacted by good funds 'management, proper positioning, a gap in spread analysis, all the financial tools.

I think as we noted in the testimony, there are variations of rates, and a well-managed institution, theoretically, is able to offer a lower rate than a poorly managed one.

Senator HAWKINS. Do you have any specific recommendations, Mr. O'Connor, for regulatory reform that would help reduce the consumer credit rate?

Mr. O'CONNOR. Yes, we did. We mentioned two in our testimony. I'll start with the second one, that's in terms of variable rate loans. Some States do restrict the capabilities of creditors to offer that type of loan. It is a fairly new phenomenon. It is only within the last 2 years that the banks have started to move in variable rate lending, but we think from the evidence, that those rates will, just by their nature, obviously change over a period of time, based on the contract, but be closer to what we're looking at in terms of the other short-term rates, the Treasury bill rate, the money market deposit rate. It certainly seems to be fairer to the consumer.

But there's a down side to that, I guess, from the consumer's standpoint, that 2 years from now those rates may be 22 percent, if money costs go up, if the index to which the loans are tied goes up.

We also believe quite strongly that deregulation of interest rate ceilings at a Federal level would produce benefits to consumers. In most cases, the 18 percent rate we're disclosing to credit card customers, usually doesn't wind up in an 18 percent yield to the bank. One must consider the free period that most credit card issuers continue to offer or are mandated to offer in certain jurisdictions. And that reduces the yield of the portfolio overall, given the fact that about one-third of the people don't pay any finance charges and are getting that service at an approximate rate of 15 percent.

So an 18 percent annual percentage rate, while certainly individual customers are charged that, on unpaid balances, the effect of the portfolio does not generate an 18 percent dollar figure back to the lender. Essentially those two (various rate lending and the deregulation of State imposed interest rate ceilings), and I would add, in the current deliberations going on in terms of the Bankruptcy Reform Act and amendments to that, certainly would help.

Senator HAWKINS. Do you know what percent of your costs are due to regulation?

Mr. O'CONNOR. I really don't. We've been asked that on several occasions. About the only definable things we can do is look at the

expenditures to implement a new regulation. Fortunately, there haven't been too many of those in the last couple years. Most of the ongoing costs become part of the day-to-day operation. So I can't really give you a good figure, X percent or X dollars of costs are attributable to regulation.

Senator HAWKINS. In your testimony, though, you had 27 percent of your costs.

Mr. O'CONNOR. Those are internal total operating costs for everything—salaries, floor space etc. They are mostly direct, and some allocated expenses, but that figure did not include funding costs or loan losses.

Senator HAWKINS. And how much of your portfolio is foreign?

Mr. O'CONNOR. In our bank, it is about 36 percent of the total loans of the banks.

Senator HAWKINS. Are they all good loans?

Mr. O'CONNOR. I don't have any involvement with our international banking function. I believe our international portfolio is slightly sounder than most of the international banks, although I guess there would be some dispute to that. The internal discussions I've heard is that we have our problems in that portfolio. I don't think anyone would deny that.

Senator HAWKINS. You stated so emphatically that it was rubbish to say that foreign loans were adding to consumers 'costs.

Mr. O'CONNOR. Well, if you look at the number of banks actually involved in international lending—I think Mr. Kennedy mentioned the figure 200. I don't have access to that information. 200 out of 14,000, plus another several thousand thrift institutions and finance organizations, cannot control interest rates on consumer loans. In addition, we've given some evidence that demonstrates there is a choice of rates—the Commissioner of Banks in Massachusetts, on a monthly basis, publishes a table in the local newspaper showing rates for car loans, personal loans and mortgages from every financial institution in the State. So consumers are being told about it. There is a wide variation of rates.

Senator HAWKINS. Where is the citation?

Mr. O'CONNOR. The citation in the testimony was the New York Bankers 'Association Study, not Massachusetts.

Senator HAWKINS. Do you know what it is in Massachusetts?

Mr. O'CONNOR. I'm afraid I don't. I know there is at least one institution offering car loans at 11.5 percent, a financial institution. I am sure there are some at 20. So one on each end. I'm not sure that constitutes a statistic, but at least those choices are there. In New York, for new car loans, it was between 13.5 and 21 percent

Senator HAWKINS. I have some other questions, but as I stated, I will submit them to you. So we will complete the record at that time.

I'd like to thank you all for being here and helping us unravel the puzzle as to why consumer credit rates have failed to decline.

The hearing is adjourned.

[Whereupon, at 2:50 p.m., the hearing was adjourned.]

[Additional material received for the record follows:]

March 7, 1983

Mr. Pat Abshire
c/o Senator Paula Hawkins
Hart Building
Washington, D.C. 20510

Dear Pat:

As you requested, I am enclosing our analysis of the responsiveness of consumer credit rates to changes in short-term interest rates for the Consumer Affairs Subcommittee of the Banking, Housing, and Urban Affairs Committee of the U. S. Senate. You understand, of course, that these are my views and those of Dr. A. Charlene Sullivan, associate director of the Credit Research Center, and are not intended to represent the views of Purdue University.

We hope that this statement will be helpful to the members of the Committee.

Sincerely yours,

Robert W. Johnson

Robert W. Johnson
Director

RWJ:mhl
enclosure

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RESPONSIVENESS OF CONSUMER CREDIT RATES TO CHANGES IN SHORT-TERM INTEREST RATES

In recent months there has been considerable discussion concerning the failure of rates on various forms of consumer credit to decline as much as the prime rate or other short-term rates, such as the rates on U.S. Treasury bills. The impatience is understandable, but should be tempered with a careful economic analysis of the factors that influence the rates charged by firms providing credit to consumers.

Overemphasis on Rates

A consumer instalment credit contract is a much more complex instrument than a 90-day Treasury bill or a $10 million three-month loan to a giant corporation with a AAA credit rating that may qualify for a loan priced at the prime rate. The latter are standardized financial contracts. Although the loans are unsecured, both Treasury securities and loans to AAA corporations would be evaluated as riskless or almost riskless. The primary cost to the lender of making these loans would be the cost of obtaining short-term money.

In contrast to these large, standardized loans, consumer credit contracts are enormously more complex and are usually tailored to limit the risk of the contract to a level justified by the rate that is charged. The risk of the contract is a function of such factors as the credit worthiness of the borrower, the relationship between the value of collateral and the outstanding balance on the loan, and maturity of the contract.

Because consumer credit contracts are multi-faceted, credit grantors may adjust a number of terms of credit contracts in response to changes in interest rates. If their costs decline because of a drop in the cost of money, they may lower the rates charged consumers (thereby reducing the return) and hold the risk of their portfolio constant. Alternatively, they may respond by making credit more available by such actions as lowering the required downpayment, increasing the maturity to reduce monthly payments, requiring less security, or accepting applicants representing a higher risk.

In summary, criticisms that focus solely on the responsiveness of rates charged on consumer credit contracts are myopic in that they overlook the many other features that characterize these contracts. Like the blind man who, upon feeling the elephant's trunk, concluded that the animal was a large, snakelike beast, so do those who examine only the rates of charge on consumer credit contracts miss the opportunity for a full analysis and understanding of how grantors of consumer credit respond to changes in market interest rates.

Costs of Providing Consumer Credit

There are three main components to the cost of providing consumer credit: operating costs, credit losses, and the cost of funds. Only the last cost is a function of changes in short-term market rates. However, we will explain why even the cost of funds for consumer credit grantors is not perfectly correlated with the level of short-term interest rates.

A. Operating costs

Operating costs comprise a major portion of the total costs of providing credit to consumers. Data from the 1981 Functional Cost Analysis for average banks published by the Federal Reserve System show the importance of operating costs of commercial banks providing consumer credit. Among large banks (those with deposits over $200 million) operating costs amounted to slightly more than one-fourth of the total costs of the instalment loan function. Operating expenses were almost 30 percent of the total costs of the instalment loan function for the smallest sized banks. As might be expected with the smaller balances involved, operating costs amounted to 45.8 percent of the costs of large banks that issued credit cards. Among small banks (those with deposits of $50 million or less) operating costs amounted to 59.0 percent of total credit card costs.

It is interesting to contrast the importance of operating costs involved in providing consumer credit with the operating costs of the commercial loan function. Whereas these costs amounted to about 46 percent of total costs for large banks issuing credit cards, they made up only 13 percent of the costs of providing commercial loans. It is not surprising, therefore, that rates on commercial loans have responded more quickly to the decline in short-term money rates than consumer credit rates.

The 1981 survey of finance companies published by the National Consumer Finance Association (now the American Financial Services Association) reveals a similar significant role of operating costs. Among large finance companies (those with assets of $1 billion or more), operating costs comprised 31 percent of total costs. In contrast,

operating costs made up 54 percent of the total costs of the smaller companies.

An extensive study of the costs of providing retail store credit cards in New York in 1974 attests to a similar importance of operating costs in providing this form of consumer credit. Shay and Dunkelberg in their study, Retail Store Credit Card Use in New York demonstrate that operating costs amounted to 37 percent of total costs for the 17 large retailers surveyed.

In summary, operating costs are an important component of the costs of providing consumer instalment credit. Since these costs are largely unrelated to interest rates, but tend to move upward with inflationary pressures, we should not expect rates on consumer credit to decline in direct response to lower interest rates. Operating costs will always provide a barrier to a direct association of rates on consumer credit with market interest rates. Also, the responsiveness will lessen as the relative proportion of operating costs to total costs increases. As we saw when comparing the proportion of operating costs to total costs in the case of commercial banks, the proportion of operating costs to total costs was much larger for the credit card function than for the instalment loan function. Thus, we would expect rates on credit cards to decline less in response to changes in market interest rates than the rates on instalment loans, especially rates on large loans, such as automobile loans.

Further, operating costs tend to make up a larger portion of total costs for small credit grantors than for large ones. Thus, any attempt to somehow limit or lower rates on consumer credit by government

intervention will adversely affect small creditors more than large ones. The exit of small firms from the industry as a result of rate controls would diminish the level of competition and would adversely affect consumers seeking credit.

B. Credit Losses

Credit losses are also not significantly affected by changes in interest rates. Among the large commercial banks surveyed in the study cited above, net losses amounted to 4.9 percent of the total costs of the instalment loan function and 10.7 percent of the costs of the credit card function. In contrast, credit losses amounted to only 4.2 percent of the total costs of the commercial loan function. Among the retailers in the New York study, bad debt losses amounted to 12.4 percent of total costs.

If anything, credit losses have increased in relation to total costs from the times of these studies, especially for unsecured credit such as that provided by bank and retail credit cards. The extraordinary losses during 1980 and 1981 following the effective date of the 1979 Bankruptcy Reform Act and the expectation of a continued high level of losses, provide a further barrier to lowering finance changes.

C. Cost of Funds

While the prime rate has declined over the past year from about 20 percent to 10.5 percent recently, it would be fallacious to assume that firms providing credit to consumers have experienced a similar reduction in their total cost of funds. The cost of funds for consumer lending is generally less flexible than short-term money rates because firms providing

consumer credit obtain only a portion of their funds on a short-term basis. In addition, the interest cost of consumer deposits to banks has recently become unregulated, thereby permitting these rates (which are costs to financial institutions) to rise to market levels or higher in areas where competition for funds was very intense.

While commercial banks have been criticized for not rapidly reducing their rates on consumer credit, their cost of funds has not declined as sharply as, say, the rates on 90-day Treasury bills. The Federal Reserve System's functional cost analysis for average banks in 1981 that was cited above shows that the large banks financed 28.3 percent of their assets with demand deposits, with the remainder being supported by longer-term deposits, such other borrowings as long-term subordinated debentures, preferred and common stocks and retained earnings. The small banks relied on demand deposits to about the same extent as did the large banks.

For some period of time the "yield curve" has been upward sloping; that is, long-term rates have been higher than short-term rates. Under this circumstance, banks find that their cost of funds increases as the maturity of this debt lengthens while short-term rates have attracted attention by their precipitous decline, that drop has not been shared by long-term interest rates.

Thus, we cannot expect banks to lower their consumer credit rates as much or as quickly as the decline in short-term interest rates for two reasons. First, banks already carry on their books long-term funds for which rates were set some time ago during periods of higher interest rates. Second, even when new contracts are made to acquire both short- and long-

term funds, the latter type of debt is available only at higher rates than currently prevail on short-term debt. In other words, because the merged cost of bank funds has not declined as rapidly as short-term rates we cannot expect the rates on consumer credit contracts, which may have maturities of four or five for new car loans, to decline as rapidly as short-term rates.

Nondepository grantors of consumer credit, such as retailers and finance companies also obtain only a portion of their funds from short-term sources, and it is only this segment that is directly and immediately affected by declines in short-term money rates such as we have witnessed in recent months. Data from the 1981 survey of finance companies show that the large finance companies with receivables of $1 billion or more obtained 44.6 percent of their funds from short-term debt, while the smaller companies gained only 31.7 percent of their funds from this source. The cost of the other funds--common stock, preferred stock, and long-term debt--is relatively fixed and does not respond quickly to changes in short-term money rates.

Historically, bank loan rates may have been more responsive than they have been recently to changes in short-term rates. As a matter of policy banks mismatched the maturities of their assets and liabilities usually borrowing short-term funds to fund longer term assets. However, painful lessons were learned in the last decade about the dangers of such a strategy in a volatile interest rate environment. To reduce the amount of interest rate risk incurred, lenders have increasingly adopted a strategy to match the maturity of their assets and liabilities in order

to "lock in" a rate of return. As a result lenders seek long-term liabilities to fund long term assets. (In this case, any loan with maturity greater than 90 days would be considered a long-term asset.) Again, as was pointed out above, short-term rates typically are more volatile than long-term rates. As a result, lenders engaged in term-matching of their consumer loan portfolio may not have experienced a significant drop in their cost of funds yet.

In summary, while the cost of funds may be related to changes in short-term money rates, grantors of consumer credit do not find that these costs decline at the same rate as short-term money rates. Depository institutions obtain only a portion of their funds from short-term debt. Moreover, they compete vigorously for consumers' savings, with the result that recently acquired depository accounts have been obtained at a relatively high cost. Nondepository grantors of consumer credit also rely on short-term funds for only a portion of their total financing needs.

The Role of Government Regulation

Some of the lack of response of consumer credit rates to lower short-term money rates can be attributed to the intervention of the government in the market for consumer credit. At least two influences contribute to the inflexibility of consumer credit rates--rate ceilings and disclosure requirements.

In a number of states rate ceilings have restricted rates charged by credit grantors below the rates that would have set by competition. Without upward flexibility in the rates that they can charge, credit grantors are less likely to reduce rates when money rates decline. To

obtain an adequate return over the business cycle, they must "average out" over the period. Were they to accept below-market rates in periods of high money rates and market rates in periods of low money rates, they would be forced to cease providing credit in some states or to restrict availability to only the least risky credit applicants.

Credit grantors that offer revolving credit are understandably loath to cut rates at this time in view of the uncertainty of future interest rates. The anticipated large federal deficits create concerns about inflation (which would affect operating costs) and interest rates (which would affect creditors' cost of funds). It would be very costly for firms providing revolving credit to cut rates now only to find that they would have to be raised again within a few months. Under the requirements of truth in lending, creditors must properly notify cardholders of future increases in rates. Further, state laws vary. Some permit the new and higher rates to apply to the full unpaid balance once a consumer has been notified of the change in rates and has elected to continue to use the credit card. Other states require that credit grantors maintain the old balances separate from the new balances, applying the old rates to the old balances and the new rates to the new balances. While the various legal requirements may be justified to protect holders of revolving credit accounts from unannounced rate increases, they also impose a cost on cardholders by reducing the incentive of credit grantors to respond quickly to changes in interest costs. Provision of variable rates on revolving credit accounts may meet this adjustment problem, but the ability of credit grantors to offer these credit arrangements is hindered by state laws that limit this type of contract or that impose below-market rate ceilings.

The Role of Competition

If competition among grantors of consumer credit is allowed to work without interference from federal or state governments, we are confident that rates on consumer credit will come down a the entire yield curve moves to a lower level. However, the decline will not be as quick or as sharp as the decrease in short-term interest rates. Our analysis of the role of operating costs, credit lo[illegible] and the cost of funds supports this conclusion, as well as the historical record of the association of consumer credit rates and short-term interest rates.

Efforts to force down the rates on consumer credit artifically would be counter-productive. Such interference in the competitive market would discourage entry by new competition such as savings and loan associations and other non-bank competitors. Further, as we have seen, such efforts would adversely affect small credit grantors relative to their large competitors. In the long run, intervention triggered by impatience and inadequate consideration of the costs of providing consumer credit would be harmful to consumers--the very group that we seek to benefit by such governmental intervention.

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